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MONETARY POLICY IN GEORGIA

- **The aim of the National Bank of Georgia's monetary policy is to maintain low and stable inflation** and thus promote macroeconomic stability, which is a precondition for robust and sustainable economic growth, low interest rates and decreasing unemployment.

- **The long-term CPI inflation target is 3%.** The inflation target was reduced gradually from 6% to its long-term value. It was 4% for 2017, and from 2018 it is 3%.

- **Since monetary policy decisions impact the economy with a certain time lag (4-6 quarters),** the formulation of monetary policy is done according to inflation forecasts in order to hit the target in the medium term. The medium term horizon depends on shocks and exogenous factors that influence the rate of inflation and aggregate demand.

- **The primary tool of monetary policy is the refinancing rate**. The change of the policy rate is transmitted to the economy through market rates, exchange rate and credit activity, thus influencing aggregate demand. The difference between the actual and natural level of demand is the main determinant of inflation in the medium term.

- **Monetary policy decisions are communicated to the general public via press releases.** The vision of the bank with regard to ongoing and expected macroeconomic activity is published in the Monetary Policy Report in the second month of every quarter.

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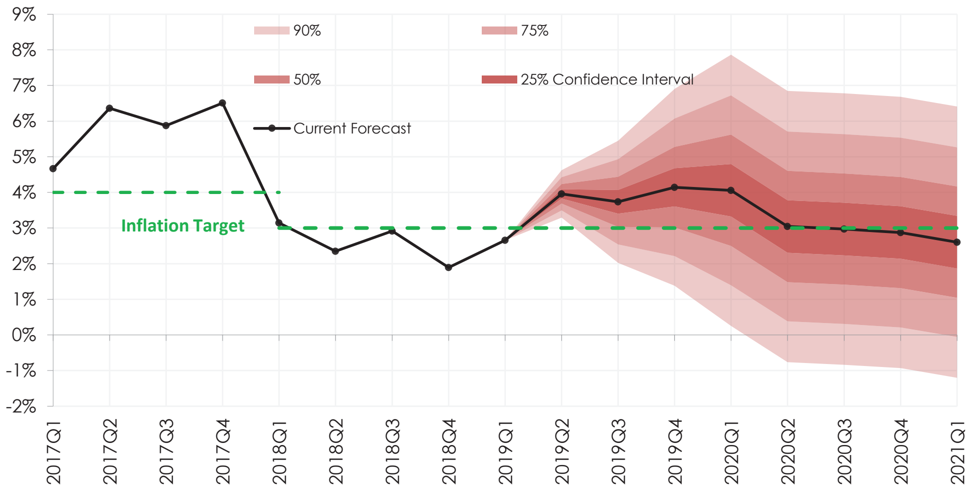
1. Brief Overview

In the first quarter of 2019, the **annual inflation rate** was as expected – standing at 2.7%. As was anticipated, the downward pressure on inflation coming from aggregate demand was offset by the intermediate costs of servicing foreign currency business loans and the increase in excise taxes on tobacco products. However, annual inflation jumped to 3.7% following an additional increase of tobacco prices in March. As a result, inflation overshot its target. It should, however, be noted that the increase in inflation as a consequence of higher excise taxes is of a temporary nature and will be neutralized from the following year.

According to the National Bank of Georgia's forecast, in the short run, inflation will remain somewhat above the target level of 3%; however, it will return to the target level next year (see Figure 1.1). According to the forecast, this year the downward pressure on inflation stemming from still-weak aggregate demand will be balanced by the effect of excises taxes on tobacco, imported inflation and the higher intermediate costs of servicing debt due to dollarization. In the medium term, alongside the elimination of one-off factors, aggregate demand is expected to increase to the potential level of output, ensuring that the inflation rate will be close to the target.

Figure 1.1 Headline CPI inflation

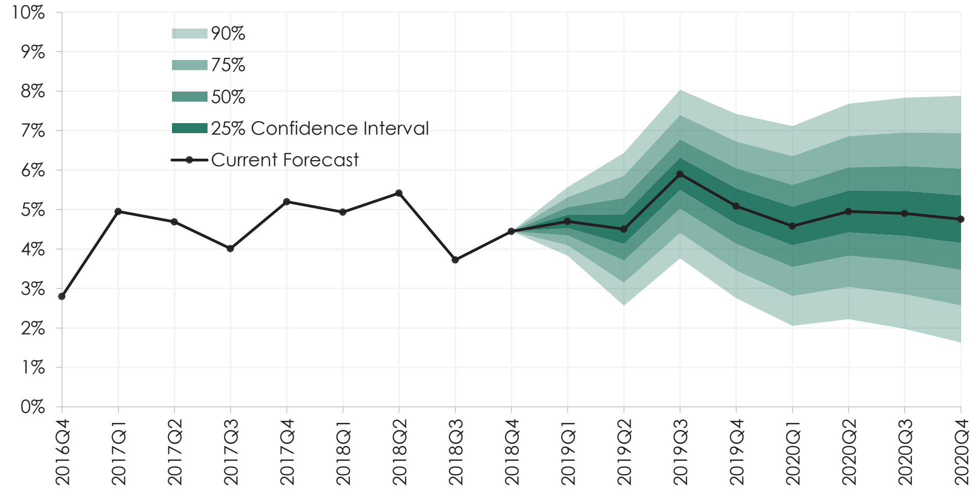


Source: National Bank of Georgia

According to preliminary data, **real GDP growth** was 4.7% in the first quarter of 2019. Economic growth in 2018 was characterized by some volatility, with growth in the first half of the year standing at 5.4%, but then falling to 4.2% in the second half. This variation was driven by both domestic and external factors. Among the domestic factors, the effect of weakened fiscal stimulus including infrastructure projects was particularly notable. In terms of external factors, in the second half of the year money transfers and tourism revenues from Turkey and Iran both fell as a result of the economic situations in those countries deteriorating. As a result, overall real GDP growth in 2018 totaled 4.7%.

The NBG's **forecast of real GDP growth** for 2019 remains unchanged at 5% (see Figure 1.2). Despite the risks stemming from a softening of economic growth in the second half of last year, the baseline scenario expects this slowdown to be only temporary. This is based on the assumptions that the moderate growth of credit activity will continue and that fiscal stimulus will be of the scale planned. According to the current forecast, net exports, consumption and investments will all positively contribute to real GDP growth. According to the baseline projection, growth will again be supported by capital spending from the government and a moderate growth of loans. Even though estimates show that the deviation of aggregate demand from the potential level of output deteriorated somewhat in the second half of 2018, it is expected that the moderately high level of economic growth will continue and that the output gap will close within the next two years.

Figure 1.2 Annual real GDP growth



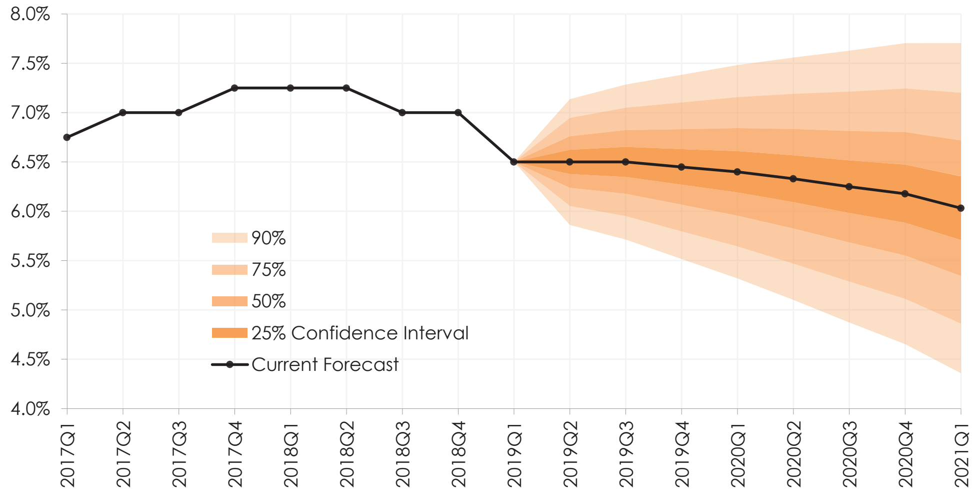
Source: National Bank of Georgia

It should be noted that monetary policy cannot aim to fully neutralize temporary factors affecting the inflation rate in the short run. That objective could only be reached through policy changes, which might lead to extreme fluctuations in economic growth and employment. Therefore, the National Bank of Georgia tries to strike a balance in its decision making, considering the expected timeframe over which the inflation rate will return to the target level and estimating the possible effects on economic growth.

In the first half of the previous year, the NBG maintained a moderately tight monetary policy to neutralize inflation risks. However, following the decline of inflation to its target level of 3%, from the second half of the year the NBG started to gradually reduce the monetary policy rate to its neutral level. The current macroeconomic forecast also envisages a **downward trend for the monetary policy rate** in the medium term (see Figure 1.3). It is worth noting that the recent increase of inflation above the target has mainly been caused by one-off factors from the supply side. In general, central banks, including the NBG, do not react to these kinds of supply-side shock because of their temporary nature. However, should such shocks be expected to lead to an increase in long-run inflation expectations, then the NBG would have an adequate response. At this stage, the normalization of the policy rate (its reduction to the neutral level) is still on course; however, and similar to the previous forecast, this process will occur only gradually – reaching the neutral level after two years. According to current estimates, the neutral level of the policy rate is around 5.5-6.0%.

It should be stressed that the monetary policy rate forecast is not a commitment to future decisions made by the National Bank of Georgia. Rather, it is the expected trajectory of the policy rate assuming that all exogenous factors incorporated into the forecast materialize as expected.

Figure 1.3 Forecast of the monetary policy rate



Source: National Bank of Georgia

The forecasts depend on **exogenous factors and contain risks in both upward and downward directions**. In terms of external factors, risks are mainly associated with the economic growth of Georgia's main trading partners, the global trends of the euro and US dollar, and international prices of oil and food. In terms of domestic factors, risks stem from changes to the fiscal deficit, credit activity and business sentiment. Hence, if external and/or domestic factors evolve differently than is currently expected, this may influence macroeconomic variables and, consequently, will affect future decisions made by the National Bank of Georgia.

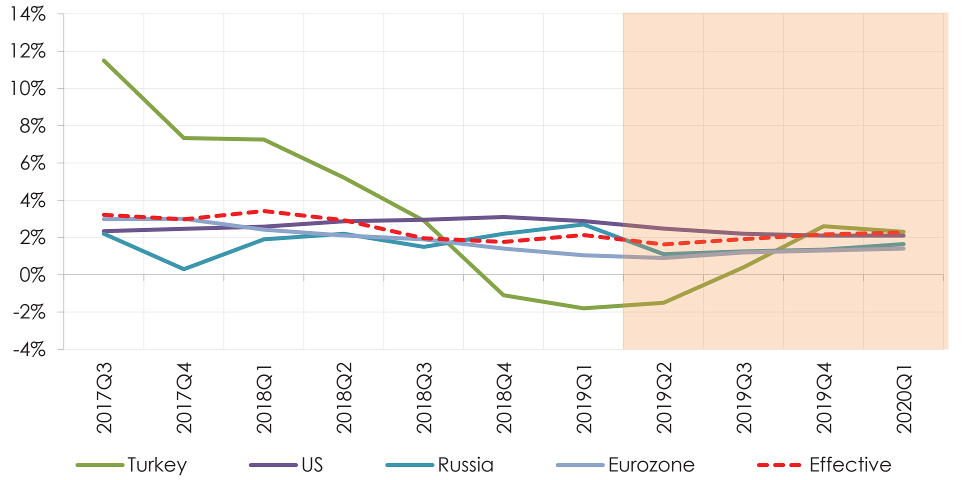
2. Macroeconomic Forecast

2.1 OVERVIEW OF EXTERNAL FACTORS

In 2018, **global economic growth** slowed to 3.6%, which was 0.2 percentage points (pp) below the previous year. This deceleration was driven by a slowdown in the growth rates of advanced economies as well as those of emerging and developing countries. According to the IMF's forecast[1], global economic activity will continue to increase, albeit weakly, through 2019 and is projected to grow at 3.3% based on preliminary estimates. On the back of the uncertainty regarding Brexit, both Great Britain and the eurozone have seen decreased domestic production and consumption, as well as lower volumes of exports and fixed investment. Although the previous year was solid for emerging and developing countries, based on the recent slowdown, the IMF has revised its 2019 growth forecast downward to 4.4%.[2]

The recovery of the **US** economy weakened in the last quarter of 2018 as a consequence of a significant reduction in fiscal and consumer spending. A similar pattern continued in the first quarter of 2019, which was supplemented by uncertainty surrounding the possibility of a "trade-war". The IMF's real GDP growth forecast[3] for the US in 2019 stands at 2.3%, which is 0.2 pp below the previous estimate[4]. Inflation is expected to remain around 2% in 2019.

Figure 2.1 Real GDP growth of economic partners



Source: Bloomberg; National Bank of Georgia.

Over the course of 2018, the **eurozone's** economy grew by 1.8%; however, the IMF projects that this growth will slow even further to 1.3% in 2019[5] – a lower indicator than previously forecast.[6] On the back of Brexit uncertainties, trade has been delayed and export volumes and the volume of investments have both decreased. Inflation in the eurozone, according to current estimates, is expected to be 1.3% in 2019.

The Georgian economy faces increasing influence from economic developments occurring in its major partner countries. Recent developments in **Turkey**, which have resulted

1 *International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.*
2 *Ibid.*
3 *Ibid.*
4 *International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, D.C., January.*
5 *International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.*
6 *International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, D.C., January.*

in a significant reduction of the country's economy, a sharp depreciation of the national currency and inflation, are especially important. In the first quarter of 2019, on the back of the tough political situation facing the country, the local currency depreciated even further. This was followed by a deterioration in consumer and business sentiment, which resulted in a further weakening of domestic demand. According to the IMF's forecast, real GDP growth in Turkey will be negative, being projected at -2.5% in 2019.[7] Annual inflation in March was 19.7%.

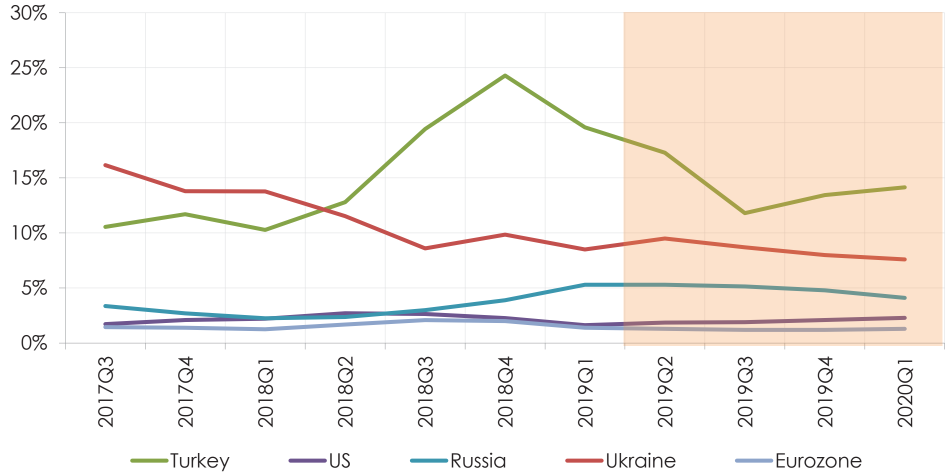
Somewhat similar to the situation with Turkey, revenues from tourists, trade and money transfers also declined from **Russia**. The recovery of the Russian economy slowed at the beginning of 2019, which was mostly driven by deteriorating consumption dynamics on the back of an increased VAT rate and the depreciation of the local currency. Furthermore, the external sector has been weak and in January exports contracted for the first time since 2016. The latter was partly a result of an agreement reached between OPEC and Russia about limiting oil production. Additionally, ongoing US sanctions continue to significantly affect the country's economic growth. According to the IMF's forecast, Russia's real GDP growth will be 1.6% in 2019.[8] Inflation in March was 5.3%.

Despite an uncertain political situation, **Ukraine's** economy continues to recover. This was mostly a result of improved labor market conditions and high domestic demand in the last quarter of 2018. Moreover, export volume increased in the first quarter of 2019. However, the grim external environment alongside political uncertainty remain significant challenges for Ukraine. The IMF's real GDP growth forecast for Ukraine in 2019 is 2.7%.[9] Annual inflation in March was 8.6%, while it is forecast to be 8% for 2019 as a whole.

Regardless of a setback in the third quarter, **Armenia's** economic growth in 2018 was solid and stood at 5.2%.[10] An improved trade balance, with exports accelerating and import growth tumbling, and stable money transfers from Russia made a positive contribution to this dynamic. The pattern continued in the first quarter of 2019. According to the IMF's forecast, Armenia's real GDP growth will be 4.6% in 2019, while inflation for the year is forecast at 2.1%.[11]

In the first quarter of 2019, **Azerbaijan's** oil sector was characterized by high levels of activity, with export volumes 50% higher than the same period last year. This was combined with accelerated growth in the non-oil sector and high fiscal spending, all of which has further stimulated the economy's recovery process. The IMF's real GDP growth forecast for of Azerbaijan in 2019 stands at 3.4%.[12] Annual inflation in March was 1.9%, while it is forecast to be 2.5% for 2019 as a whole.

Figure 2.2 Headline inflation rates of economic partners



Source: Bloomberg; National Bank of Georgia.

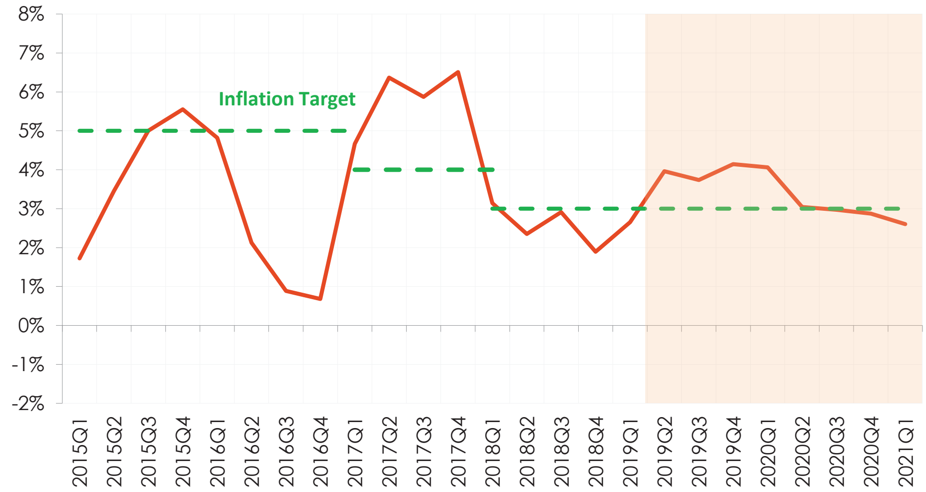
7 International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.
8 Ibid.
9 Ibid.
10 National Statistical Service of the Republic of Armenia, https://www.armstat.am/en/?nid=12&id=01001
11 International Monetary Fund. 2019. World Economic Outlook: Growth Slow Down, Precarious Recovery. Washington, D.C., April.
12 Ibid.

Despite high levels of inflation and sharp depreciations of their local currencies, the central banks of Turkey, Ukraine and Russia each kept their key policy rates unchanged in March 2019. This should help encourage domestic demand in the background of the slowdown of global growth. However, these banks are indicating a possible tightening in the future. As for the US Federal Reserve, based on current estimates, the federal funds rate will stay unchanged at 2.5% until the end of 2019. The European Central Bank also plans to keep its policy rate unchanged at 0%.

2.2 MACROECONOMIC FORECAST

In the first quarter of 2019, annual headline inflation averaged 2.7% (see Figure 2.3) – in spite of the fact that the March figure slightly exceeded the target and stood at 3.7%. In annual terms, consumer prices continued to be influenced by downward pressure coming from aggregate demand and imported product prices (amid weak foreign effective inflation), while upward pressure was a result of one-off factors. Of the latter, the greatest contributions were made by heightened prices on bread and cereals at the end of last year and, more recently, by the elevated excise tax on tobacco products and soaring oil prices.

Figure 2.3 Headline CPI inflation



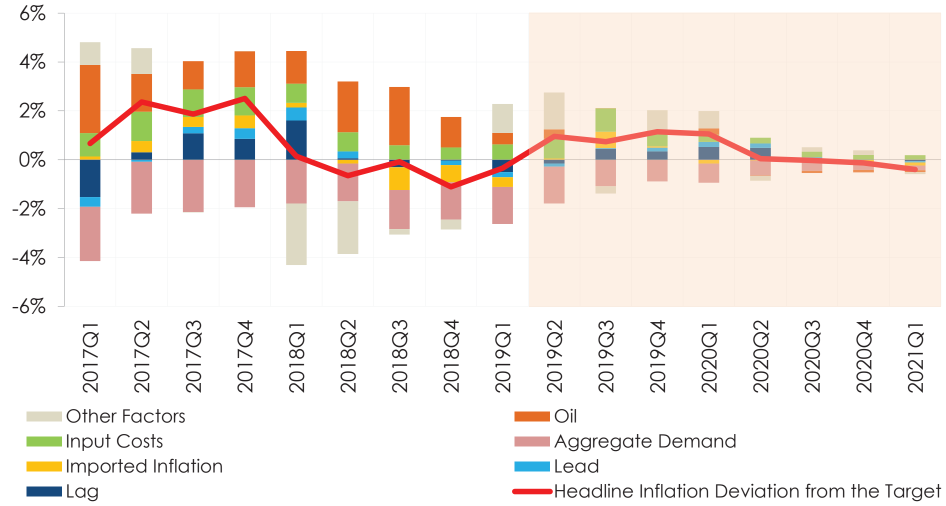
Source: National Bank of Georgia.

According to the current forecast, annual inflation, mainly due to one-off factors, will hover above the target to average 4% this year. Nevertheless, over the medium term, as the effects of the excise tax rise and other factors fade out, inflation will return to the target and remain close to it. This process will be assisted by the counterbalancing of opposing factors: elevated input costs due to dollarization and higher import prices will push inflation up, while continued sluggish aggregate demand will depress it (see Figure 2.4).

The inflation rate might deviate from its projected path if certain less probable, albeit still plausible, factors materialize. On the one hand, a substantial increase in consumer prices could be driven by a deterioration of geopolitical and economic conditions in the region. Realization of such risks may lead to increased risk premiums for the whole region, including Georgia. This would cause a depreciation of local currencies and, because of increasing payments on foreign currency loans, this would then drive annual inflation above the predicted level. Another potential cause of upward pressure on inflation could be a sharp increase in international commodity prices (of oil and food). On the other hand, consumer prices could be lower than expected if domestic demand decreases, which itself would depend on the size of fiscal stimulus and on the growth of credit activity. Furthermore, regardless of the recent thawing, the ongoing "trade war" between the US and its main trading partners contains certain risks. If this were to cause a global depreciation of the US dollar, the corresponding appreciation of the lari exchange rate might reduce the credit burden of firms and lower inflation expectations, which would ultimately make consumer products cheaper.

In the first quarter of 2019, real GDP grew by 4.7%. The growth in the previous year was 4.7%, but was characterized by marked volatility (see Figure 2.5). The average annual growth in the first half of 2018 was 5.4%, but this fell to 4.2% in the second half. The factors that adversely affected economic activity were the tapered fiscal stimulus, including from infrastructure projects, and the unfavorable situations in Georgia's partner countries, which were reflected in weakened money transfers and tourist revenues. As was the case in 2017, net exports drove economic growth in 2018 (see Figure 2.6).

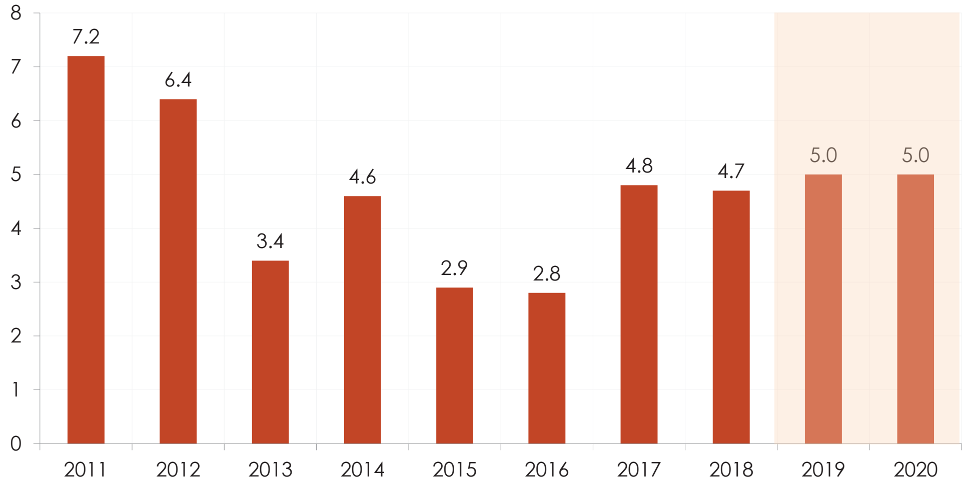
Figure 2.4 Deviation of inflation from the target and its decomposition[13]



Source: National Bank of Georgia.

According to current projections, economic activity will increase by 5% in 2019, with almost equal contributions coming from consumption, investments and net exports (see Figure 2.6). In this regard, the dynamics of fiscal spending, specifically on infrastructure projects, will be crucial. In addition, while a competitive exchange rate is maintained, net exports will continue to improve, despite their recent slowdown.

Figure 2.5 Real GDP growth

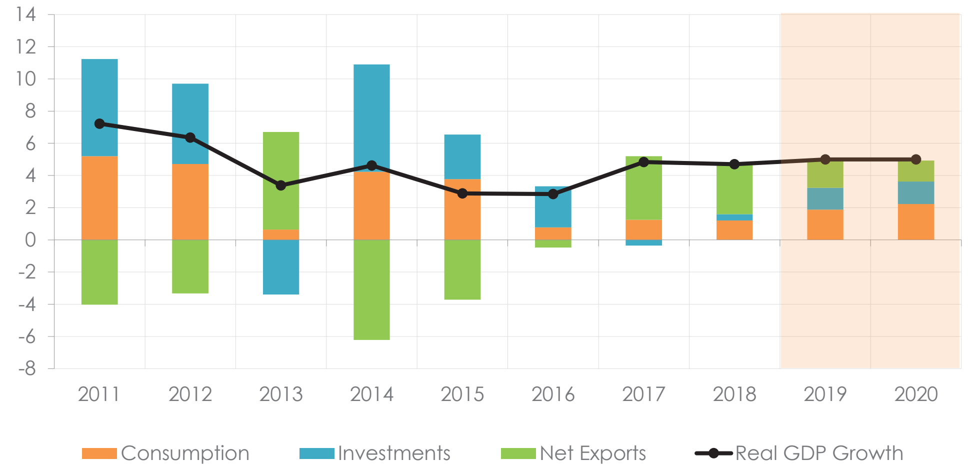


Source: National Bank of Georgia.

The current forecast of real GDP might deviate from the actual path if some less probable, yet still plausible scenarios unfold. In this regard, it is important to mention the risks to economic growth. If fiscal stimulus remains weak or the growth of the credit portfolio is less than expected, then economic activity will grow at a slower rate than predicted. Moreover, any deterioration of the geopolitical environment would increase sovereign risk premiums in the region and lead to a decrease in financial inflows. The latter would negatively affect business sentiment and investment, thereby ensuring that economic activity will be lower than expected. Conversely, if business sentiment improves, then investments and the resulting economic activity will be higher than expected.

13 In the figure, positive values for the bars indicate the above-equilibrium values of variables that have upward pressure on inflation and vice versa for the negative values.

Figure 2.6 Real GDP growth decomposition



Source: National Bank of Georgia

According to preliminary data, the **current account to nominal GDP ratio** amounted to -10.9% in the last quarter of 2018 and averaged -7.7% over the year as a whole. This was due to a significant increase in export revenues, including from tourism. According to both short- and medium-term projections, the current account deficit to GDP ratio will improve, based on the assumptions that the situation in trading partners will not sharply deteriorate and that the stable influx of trade and other revenues from other countries will persist. This will be helped further by the real effective exchange rate being maintained within competitive bounds.

Inflation forecast targeting is the most efficient framework to reach the ultimate goal of the National Bank of Georgia: **price stability**. To ensure that inflation reaches the target level in the medium term, the NBG uses the monetary policy rate. Under the inflation-targeting framework, the NBG also takes into account aggregate output. Hence, responses to supply-side shocks are gradual and balanced in order to avoid high output volatility. Gradual changes to the policy rate are considered optimal, not only in times of uncertainty but also for efficiently controlling long-term interest rates. The inflation forecast includes the interest rate forecast, which takes each of the above-mentioned factors into account.

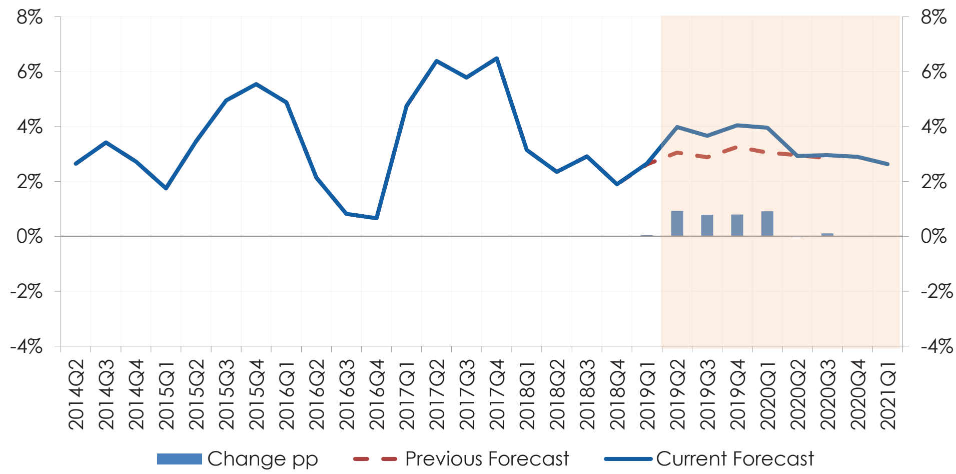
As was noted in the discussion of current forecasts, as the effects of one-off factors fade out, the annual inflation rate is predicted to return to the target in the medium term; however, aggregate output still remains weak compared to its potential level. Therefore, a continued gradual normalization of short-term interest rates is expected (see Figure 1.3). The monetary policy forecasts are based on inflation forecasts; however, the above-target inflation forecast for the current year is related to one-off factors on the supply side. As such shocks are temporary, they do not have much influence on the medium-term forecasting horizon and thus central banks, including the National Bank of Georgia, do not commonly react to them. However, if the supply shock is sufficiently large that it results in elevated long-term inflation expectations, then the National Bank will respond. At this stage, a gradual normalization of the policy rate (a reduction to its neutral level) is still on track. Current projections, which are in line with previous forecasts, see the policy rate returning to the neutral level – estimated to be 5.5-6.0%– after a two-year period.

It should be stated that the forecast of the **monetary policy rate is not a promise from the National Bank of Georgia regarding future decisions**. It only reflects the expected trajectory of the policy rate, assuming that all exogenous factors incorporated into the forecast materialize as expected. Consequently, if incoming future data presents a different picture from that which has been predicted, then the monetary policy response will be different. Despite the inherent uncertainty characteristic of any projection, the forecast contains valuable information regarding the expected path of short-term lari interest rates – upon which long-term rates depend.

2.3 COMPARISON WITH THE PREVIOUS FORECAST

The inflation forecast has been revised upward compared to the previous projection (see figure 2.7). This upward revision was mostly driven by a higher-then-expected increase in tobacco prices due to increased excise tax. In March 2019, tobacco prices rose significantly, contributing 1.3 pp to inflation. The revised forecast thus incorporates the higher contribution of tobacco prices to headline inflation. This revision was also driven by increased oil prices on international markets. According to the revised forecast, inflation in 2019 is expected to remain at around 4%, slightly higher than the target level. However, in the medium term, the impact of the excise tax increase will dissipate and headline inflation is predicted to decline to the target level of 3%.

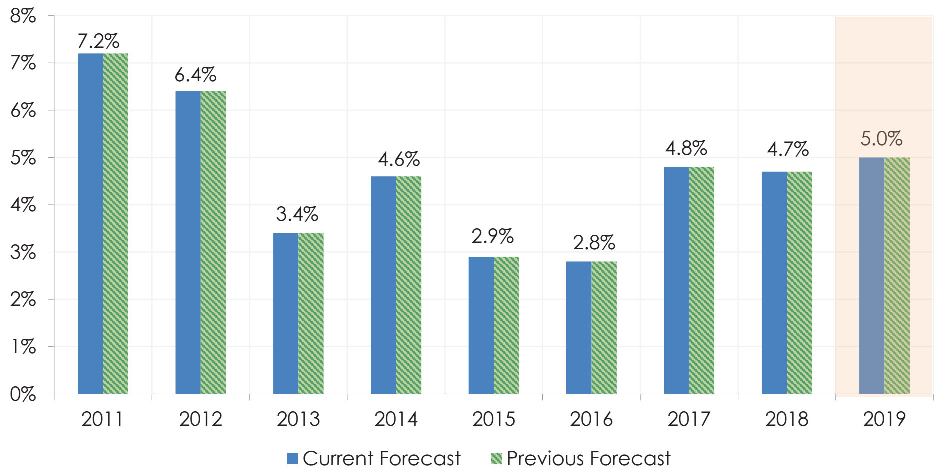
Figure 2.7 Changes in the forecast of headline inflation



Source: National Bank of Georgia

As for economic activity, the 5.0% real GDP growth forecast for 2019 remains the same as predicted in the previous quarter (see Figure 2.8). Assumptions regarding the main contributors to that economic growth have also remained the same, including those regarding credit growth and the budget deficit.

Figure 2.8 Changes in the forecast of GDP growth

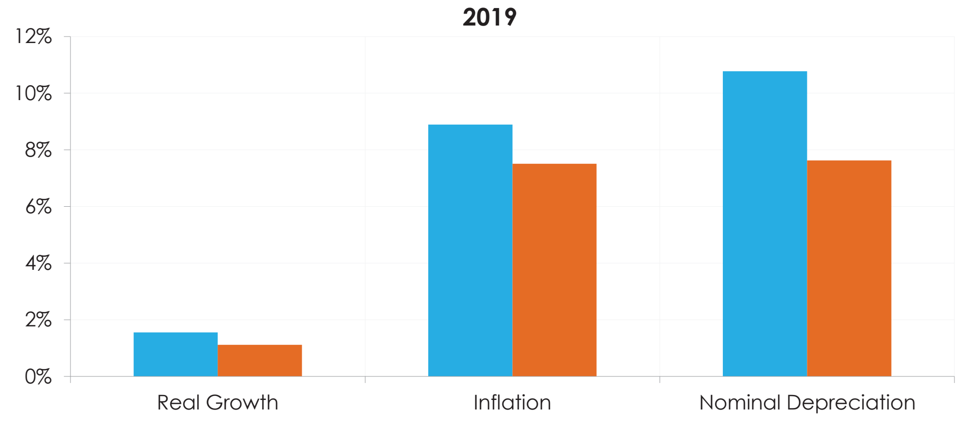


Source: National Bank of Georgia

Assumptions regarding economic growth, inflation and the exchange rates of Georgia's main trading partners are particularly important for the macroeconomic forecast. Changes in these assumptions affect the baseline forecast as well as associated risks (see Figure 2.9).

Assumptions regarding the economic growth of all of Georgia's main trading partners were revised downward, mainly due to heightened downside risks to medium-

Figure 2.9 Changes in external sector assumptions for 2019[14]



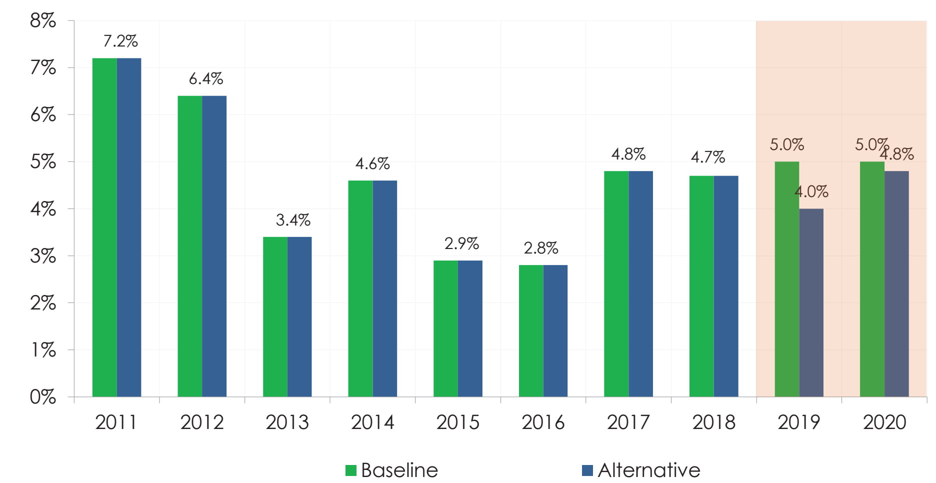
Source: National Bank of Georgia

term global economic growth. Expectations about a depreciation of the currencies of trading partners declined, primarily a consequence of an expected weakening of the USD against other currencies. In line with slower economic growth and lower-than-expected depreciation, inflation expectations for Georgia's trading partner countries have been revised downward. Although weak economic growth in trading partners would suppress external demand for Georgia, the smaller depreciation of trading partners' currencies would improve the competitiveness of Georgia.

2.4 ALTERNATIVE FORECAST SCENARIO

In the alternative forecast scenario, aggregate demand increases at a slower pace than in the baseline forecast. Since the start of 2019, credit activity has slowed as a result of new regulations enacted on responsible lending to individuals. In line with the NBG's expectations, credit growth declined and in March the credit lending rate increased by approximately 15% YoY (excluding the exchange rate impact). To put this in perspective, in 2018 the credit growth rate fluctuated at around 20%. Under the alternative forecast scenario, the effect of new macroprudential regulations on household borrowing is assumed to be higher than in the baseline forecast, with a greater reduction in the growth of credit activity suppressing domestic demand and causing real economic growth to slow. Moreover, the alternative scenario considers a lower-than-expected increase in FDI and a smaller budget deficit.

Figure 2.10 Real GDP growth according to the baseline and alternative forecasts



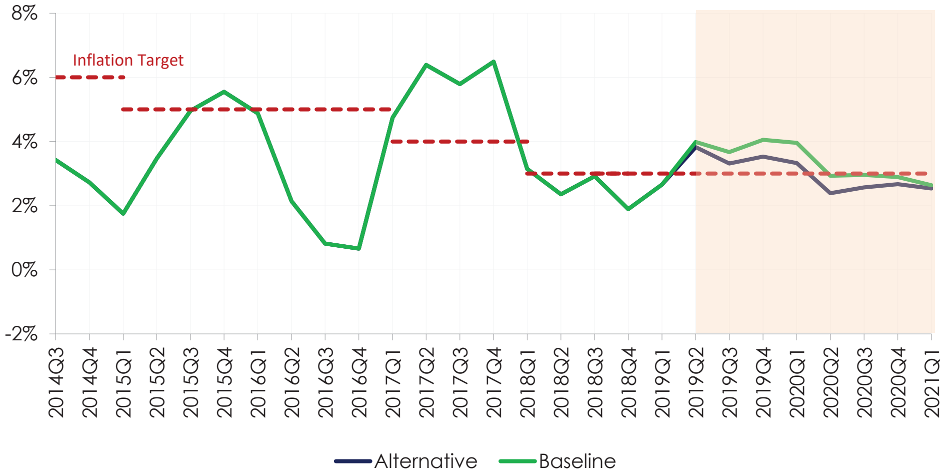
Source: National Bank of Georgia

14 *Calculations are based on the forecasts for the five main trading partners of Georgia: the US, the EU, Turkey, Ukraine and Russia.*

Realization of the abovementioned risks would subdue domestic demand as compared to the baseline scenario. Accordingly, under the alternative scenario, annual real GDP growth is lower and equals 4% (see Figure 2.10).

Under the alternative forecast scenario, weak aggregate demand suppresses the growth of consumer prices and the inflation rate is lower than the target. The scenario builds upon the assumption that, due to weak demand, the growth of imports is slow while external conditions will not deteriorate. According to the alternative forecast scenario, over 2019-2020 inflation will be 0.4 percentage points lower than in the baseline projection (see Figure 2.11).

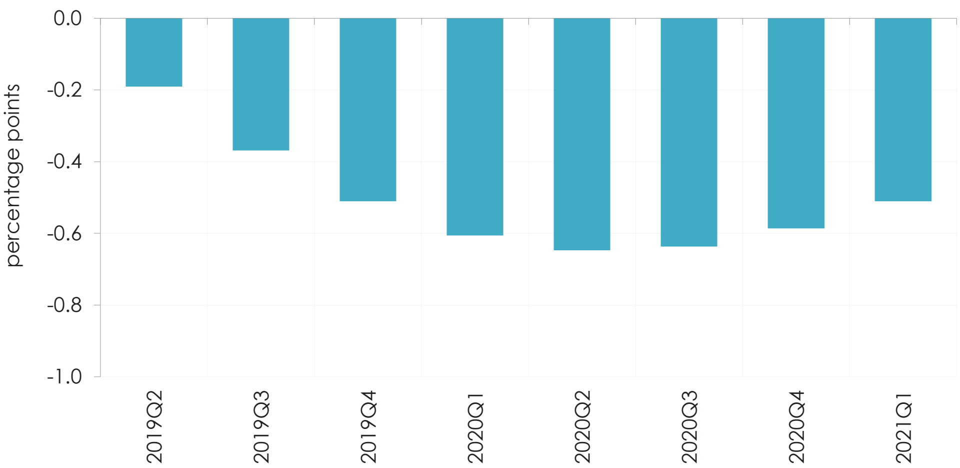
Figure 2.11 Headline CPI inflation according to the baseline and alternative forecasts



Source: National Bank of Georgia

In response, to support aggregate demand and push inflation back towards its target, monetary policy neutralization will occur faster than in the baseline scenario. Under the alternative scenario, the monetary policy trajectory will shift down by 0.5 percentage points compared to the baseline scenario (see Figure 2.12). However, the easing of monetary policy will eventually drive inflation to the target level of 3% in the medium term.

Figure 2.12 The difference in the monetary policy rate in the alternative and baseline scenarios



Source: National Bank of Georgia

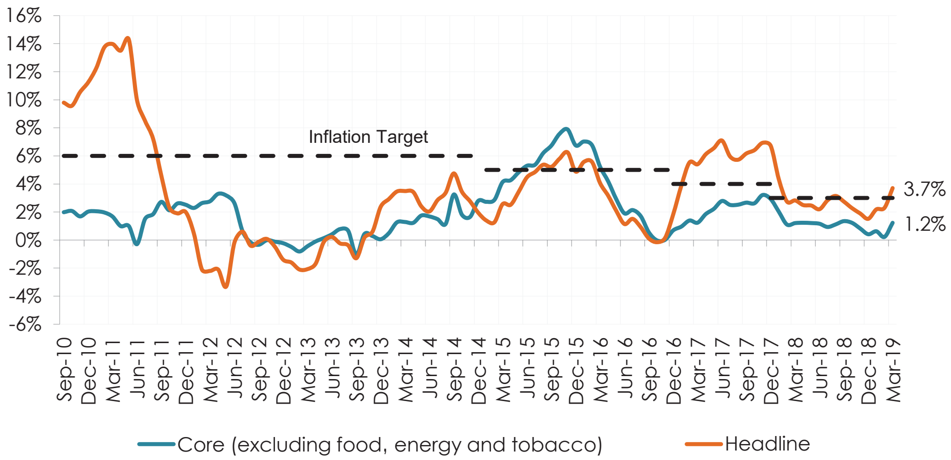
3. Consumer Prices

Since the beginning of 2019, inflation has remained close to the target level of 3%. In March, annual inflation equaled 3.7%. The main reason behind the growth was the rise was increased prices on cigarettes, which followed the rise of excise tax from the start of 2019. Of the 3.7% inflation in March, the contribution of cigarettes equaled 1.3 percentage points (pp) (see Figure 3.1).

‹‹ The rise in inflation is mostly related to increased prices on cigarettes.

Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, was substantially lower than headline inflation and stood at 1.2% in March (see Figure 3.1). The analysis of core inflation is significant as it reflects the long-term trend. Lower core inflation signals a reduction of headline inflation in the future.

Figure 3.1 Headline and core inflation



Source: GeoStat

In March, inflation in the food group equaled 5.1%. Due to the substantial weight food has in the consumer basket (27.3%), its contribution to overall inflation was 1.4 pp. Of this increase, the most significant share came from the price increase on bread, which occurred in December. The latter made a 0.5 pp contribution to inflation in March.

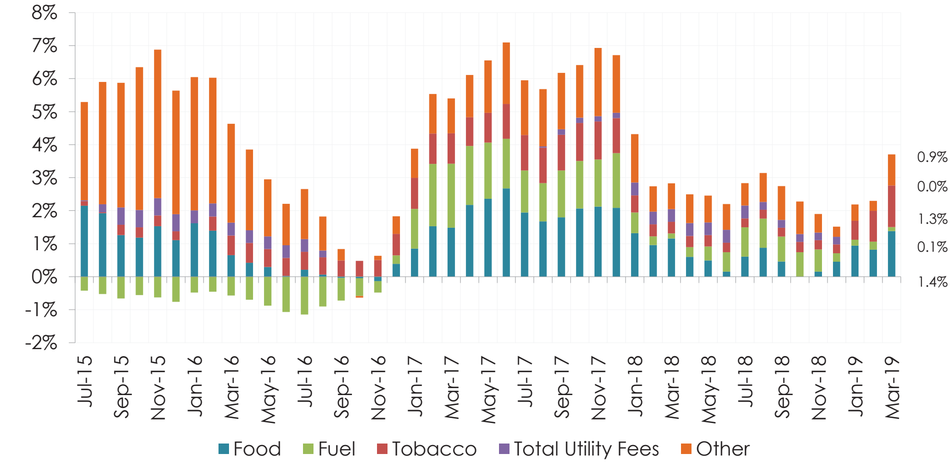
‹‹ The contributions of tourism services and food to inflation were also high.

Touristic travel also made a significant contribution to inflation in March. This is a new product that was added to the consumer basket from the current year. Prices on touristic travel increased by 13% annually and this had a 0.4 pp share in inflation.

The trend of decreasing prices on shoes and clothes evident in recent years has continued. In March, prices in this group were 10.1% cheaper than in the same period in 2018 and the negative contribution from this group to inflation amounted to 0.4 pp.

Fuel prices made a significant contribution to inflation during the last year. However, in March the contribution was only 0.1 pp – its lowest level in the last two years. This was related to a global decrease in oil prices.

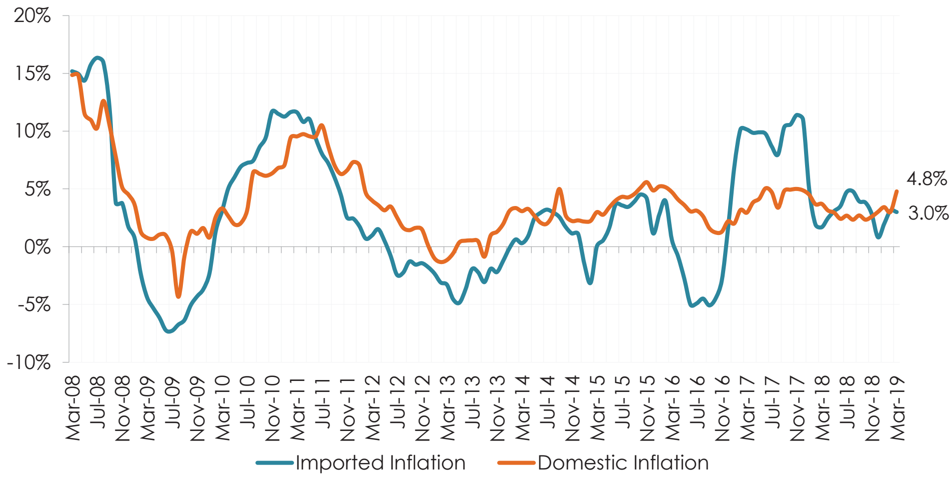
Figure 3.2 Contribution of tobacco, fuel, food and utilities inflation to headline inflation



Source: GeoStat

In March, annual inflation on imported, mixed and domestically produced goods equaled 3.0%, 1.4% and 4.8% respectively (see Figure 3.3).

Figure 3.3 Imported and domestic inflation



Source: GeoStat and National Bank of Georgia

Box 1 Exogenous factors influencing inflation

Central banks do not usually react to exogenous (independent from monetary policy) shocks, except for the cases when these kind of shocks affect medium and long-term inflation expectations.

Monetary policy is a tool influencing aggregate demand. Therefore, reacting to exogenous cost push shocks, would cause unnecessary fluctuations and have a negative impact on both long-term growth and employment. Thus, assuming there is sufficient trust in the central bank, permitting a temporary deviation of inflation from the target is expedient during a supply shock.

One example of an exogenous shock leading to price rises is a bad harvest (of wheat, sugar cane, etc.), which causes a price increase on corresponding products and a rise of inflation. For instance, several years ago a bad sugar cane harvest was experienced by the main sugar-producing countries. This caused a global price increase on sugar and products containing sugar, including in Georgia. In consecutive years, global sugar prices decreased following the recovery of the harvest. Besides price changes on commodities on international markets, changes to taxes and regulated prices are further examples of exogenous shocks.

During the last several years, the most important exogenous factor impacting the inflation rate in Georgia was the influence of an increase of excise taxes on fuel and cigarette prices. Due to the large weight of these products in the consumer basket (5.8% and 2.9% respectively) the price rise on these had a substantial impact on the inflation rate in

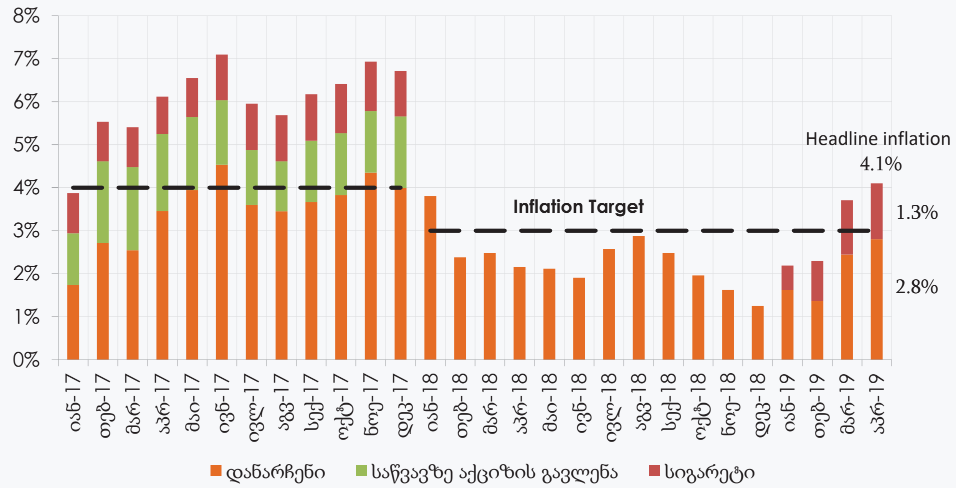
2017, causing it to exceed the target level throughout the year (see Figure 3.4). Without these one-off factors, inflation would have remained below the target.

Obviously, the reaction of a central bank's monetary policy in cases similar to those described above would not be expedient. In such cases, the National Bank's moderately tightened policy was intended to curb increased inflation expectations. At the same time, the National Bank actively communicated with the general public to explain the reasons for the rise in inflation. Contemporary forecasts indicated that there would be a decrease in the inflation rate following the expiration of the excise tax effect. These proved accurate. After the expiration of that effect, inflation substantially decreased and generally stood below the target level in 2018.

According to the agreement signed between Georgia and the European Union, the excise tax on cigarettes will increase further. The rise in excise tax during 2019 has caused inflation to exceed the target. It reached 4.1% in April, of which 1.3 percentage points came from cigarettes.

In spite of this rise in inflation, according to the National Bank's observations, inflation expectations have not risen and it is forecast that, after the expiration of one-off factors, inflation will move down towards the target level in the medium term – just as happened at the beginning of 2018.

Figure 3.4 Exogenous factors influencing inflation

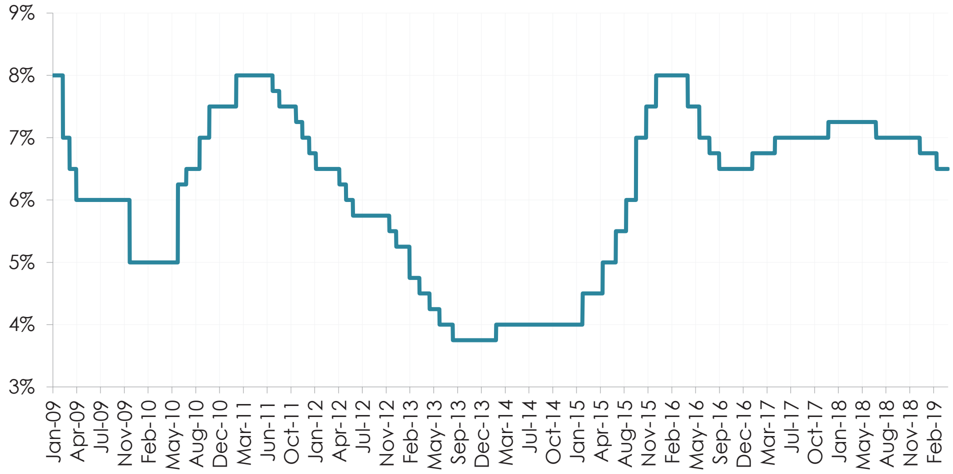


Source: GeoStat, National Bank of Georgia

4. MONETARY POLICY

From early 2019, inflation was around the target level of 3%. Hence, in the first quarter of 2019, considering the weakening of external sector risks, the NBG continued its gradual exit from the moderately tightened monetary policy stance, which started in July 2018. As a result, the Monetary Policy Committee made the decision to cut the policy rate by 0.25 basis points in both January and March to 6.5%. In the first quarter of 2019, annual inflation equaled 2.7%, while in April inflation stood at 4.1%. The latter was mostly the result of one-off factors – specifically, the contribution of the increased excise tax on tobacco equalled 1.3 percentage points.

Figure 4.1 Monetary policy rate



Source: National Bank of Georgia

At the last Monetary Policy Committee meeting, which was held on 1 May 2019, the decision was made to keep the refinancing rate unchanged at 6.5%. Considering the external sector risks, and despite aggregate demand still lagging behind its potential level, it is predicted that the NBG will continue to ease the policy rate gradually. Therefore, at a current stage the national bank deemed appropriate to keep policy rate unchanged.

From early 2019, inflation was around the target level of 3%. In April, inflation equaled 4.1%, which was mostly the result of one-off factors. Namely, the contribution of the increase of excise tax on tobacco from 2019 equaled 1.3 percentage points.

The Economic activity continues to grow moderately. However, aggregate demand is still lagging behind its potential, hence the demand side pressure on inflation is weak. According to preliminary estimates, in March economic growth was 6.0%, while in the first quarter of the year growth totaled 4.7%. Meanwhile, credit activity grew at a modest rate (rising by 13% in March, excluding the exchange rate effect). Positive trends in the external sector have persisted in 2019. In particular, export of goods rose by 13% in the first quarter. At the same time, tourism revenues and remittances both exhibited modest growth of 5% and 6% respectively. It is also important to highlight that, compared to last year, import dynamics in the first quarter of 2019 were reversed and declined by 5%. As was the case in 2018, dynamics in the external sector have contributed to the improvement of the current account balance.

According to the current forecast, over 2019, due to one-off factors, annual inflation will be above the target level. However, in the beginning of the next year, along with the exhaustion of this factors, inflation will return to its target level. Meanwhile, in the medium term, as temporary factors peter out, inflation will remain close to the target. It is important to highlight that over 2019, mainly one-off factors will exert an upward pressure on inflation. In particular, the increase in excise tax in the beginning of the year and higher than anticipated growth of the prices of tobacco products together with the increase in price on bread last year. In addition, rising prices on oil products will push inflation upwards. However, the effect of these factors will be offset by weak aggregate demand and lower prices on imported goods.

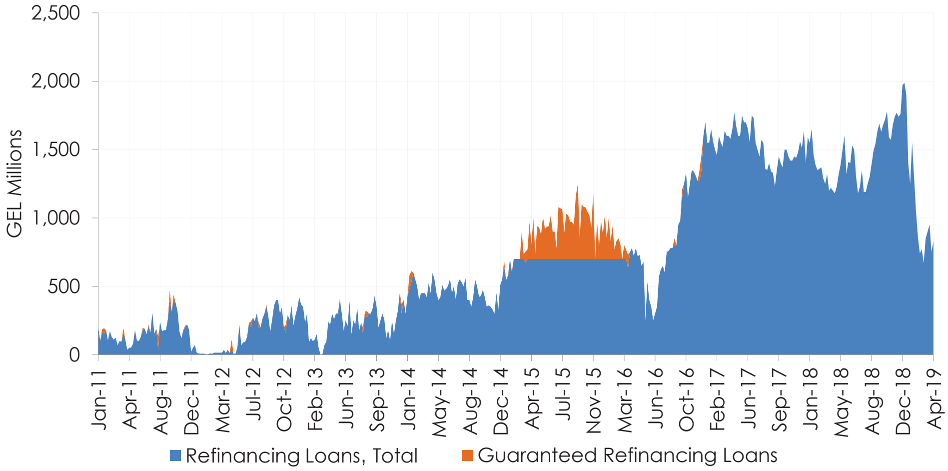
Nonetheless, several major risks to the inflation forecast remain. Inflation will be lower than anticipated if demand is weaker than expected, which will depend on the strength of fiscal stimulus and the growth of lending activity. Conversely, inflation may be higher than expected if geopolitical and economic conditions in the region deteriorate or if prices on international markets grow. Inflation may also be greater than expected if, following a deterioration of geopolitical conditions, increased risk premiums in the region (including in Georgia) cause a depreciation of local currencies and thereby increase the debt service burden on foreign exchange loans.

The Monetary Policy Committee has made the decision to increase the reserve requirements on foreign currency liabilities with a maturity up to one year from 25% to 30% and from 10% to 15% for foreign currency liabilities with a remaining maturity of 1-2 years. This decision was prompted by the larization (de-dollarization) priority of the National Bank. In addition, reserve requirements for foreign currency liabilities serve as a buffer and are used for prudential purposes. Therefore, the existence and strengthening of such buffers is important for increasing the sustainability of the financial sector.

‹‹ The reserve requirements on foreign currency liabilities with a maturity up to one year and with a remaining maturity of 1-2 years were increased to 30% and 15%, respectively.

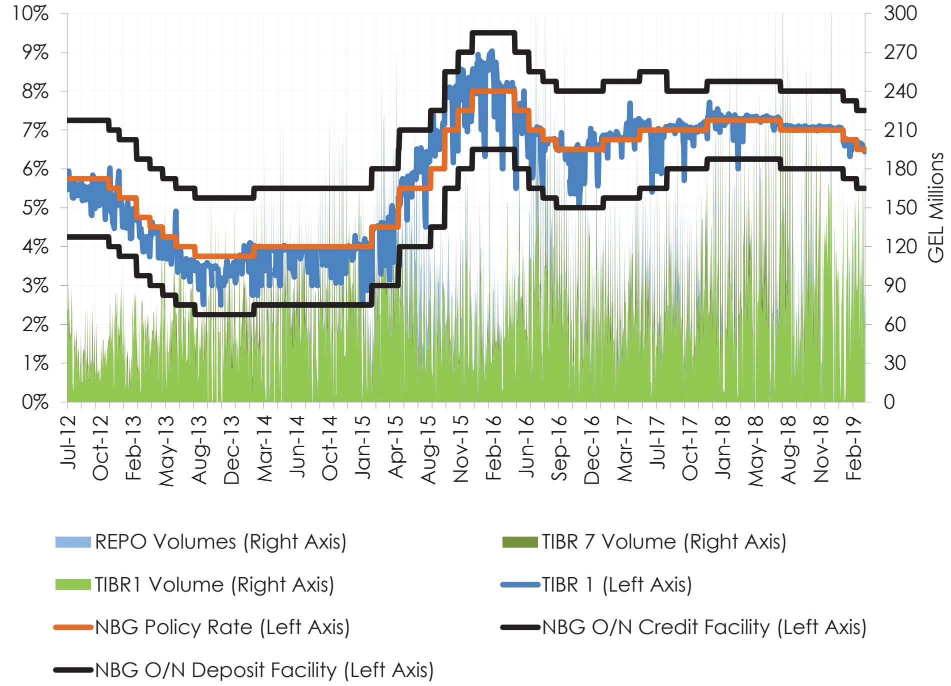
To ensure the efficiency of monetary policy, it is important for changes in the monetary policy rate to be reflected on interbank interest rates and to ultimately affect the real economy. Currently, the banking sector operates under a short-term liquidity deficit. To manage short-term liquidity, the banking sector mainly relies on refinancing loans and the interbank money market. The National Bank provides short-term liquidity to the banking system via one-week refinancing loans and one-month open market operations. Currently, interbank money market interest rates vary around the monetary policy rate.

Figure 4.2 Liquidity supply instruments



Source: National Bank of Georgia

Figure 4.3 Interbank money market



Source: National Bank of Georgia

‹‹ The interbank money market interest rates move around the monetary policy rate.

5. Financial Market and Trends

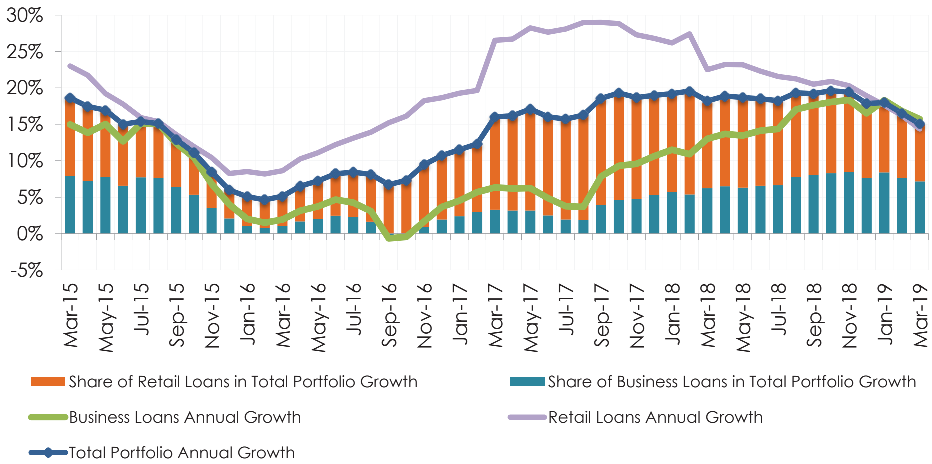
5.1 LOANS

In the first quarter of 2019, the annual growth rate of the credit portfolio declined. This stood at 15% in March, excluding the effect of exchange rate fluctuations. In March, relative to December, the growth rate of retail loans declined by 4.5 pp and stood at 14.4%; while loans to legal entities decreased by 0.8 pp and equaled 15.7%. It is important to note that in terms of loans to legal entities, one the most sizable loans in the system, totaling 300 million GEL, was covered during this period. If the latter were excluded, the growth rate of the credit portfolio would have been bigger.

The growth of business loans was primarily driven by an increase in the trade, energy, construction and transport sectors; whereas increases in credit for the manufacturing and agriculture sectors were insignificant. According to the credit conditions survey, representatives of the banking sector expect a slight increase in demand for business loans; whereas no significant change in demand for retail loans is expected.

« According to the credit condition survey, representatives of the banking sector expect a slight increase in demand for business loans and no significant change in demand for retail loans.

Figure 5.1 Annual growth rates of retail and business loans (excluding the exchange rate effect)

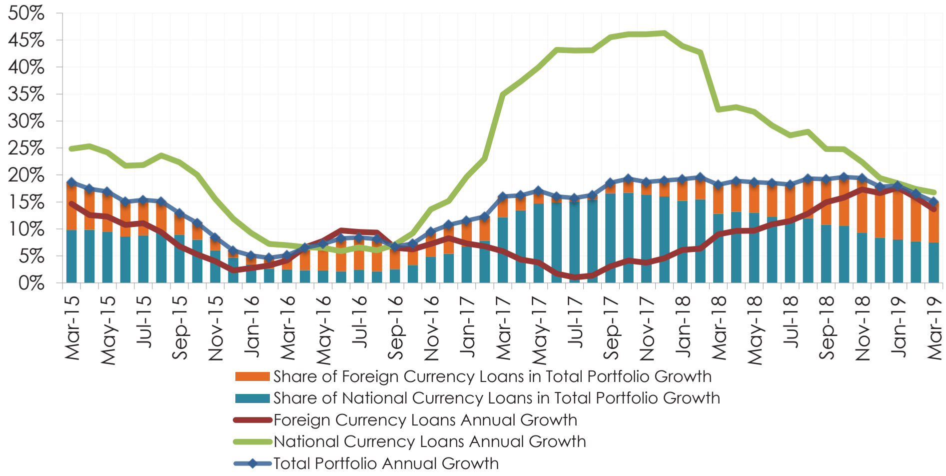


Source: National Bank of Georgia

In terms of currencies, in the first quarter of 2019 domestic and foreign currency loans made an equal contribution to credit portfolio growth (see Figure 5.2). In March, the annual growth rate of foreign currency denominated loans was 13.6%, while loans in domestic currency grew by 16.8%. In the first quarter, the loan larization ratio increased by 0.4 pp to equal 43.1%. It is expected that loan larization will increase as a result of the regulations on responsible lending and the prohibition from issuing loans in foreign currency under 200,000 lari.

« In terms of currencies, in the first quarter of 2019 domestic and foreign currency loans made an equal contribution to credit portfolio growth.

Figure 5.2 Annual growth rates of domestic and foreign currency loans (excluding the exchange rate effect)

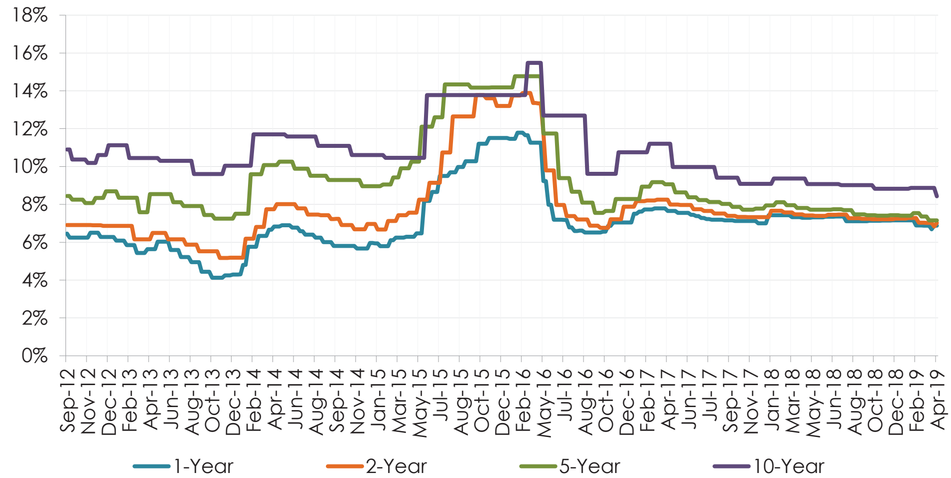


Source: National Bank of Georgia

5.2. INTEREST RATES AND CREDIT CONSTRAINTS

In March, the monetary policy rate was 6.5%. In the first quarter of 2019, interest rates on government securities revealed a declining trend. This was a result of an easing of monetary policy, a reduction of interest rate fluctuations (as well as maturity premiums) and expectations of a further easing of monetary policy in the medium term (see Figure 5.3).

Figure 5.3 Interest rates on government securities

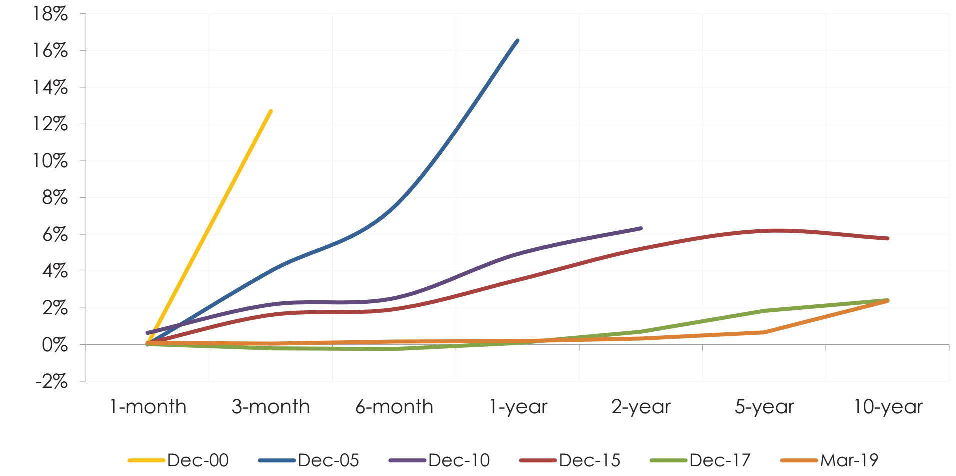


Source: National Bank of Georgia

Compared to the previous quarter, the spread between long-and short-term interest rates have not changed significantly (see Figure 5.4). This indicator remains at a low level, which suggests the increased credibility of monetary policy instruments and the improved predictability of the monetary policy rate.

« The spread between long- and short-term interest rates have not changed significantly.

Figure 5.4 Spread between the monetary policy rate and the yield curve

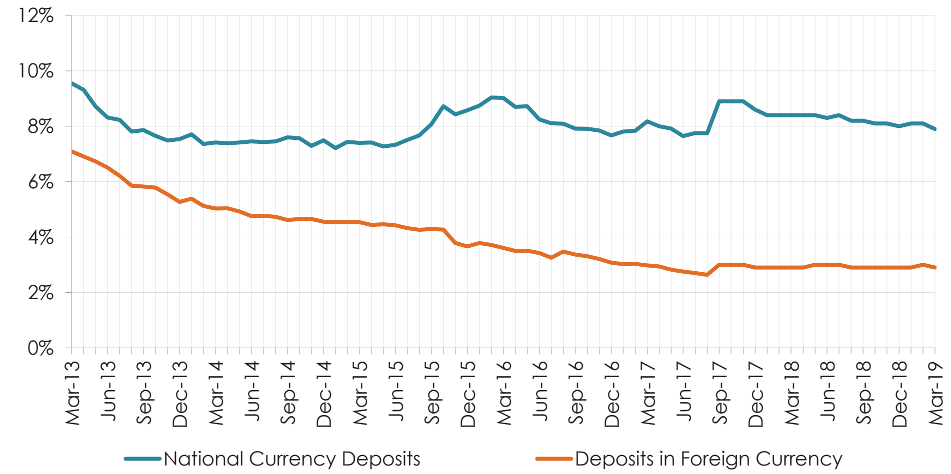


Source: National Bank of Georgia

In March, relative to December, interest rates on domestic and foreign currency deposits did not change significantly and equaled 7.9% and 2.9% respectively. According to the credit conditions survey, as a result of changes in regulatory requirements, representatives of the banking sector expect a slight increase in cost for foreign currency funds in the next quarter.

« Representatives of the banking sector expect a slight increase in cost for foreign currency funds.

Figure 5.5 Average interest rates on deposits



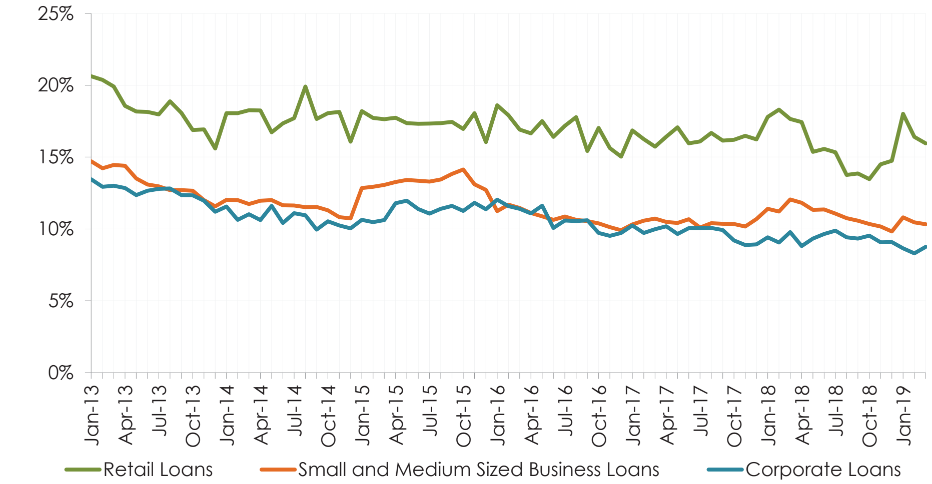
Source: National Bank of Georgia

According to the credit condition survey, non-interest conditions for corporate lending have not changed significantly. However, lending conditions for individuals have tightened due to restrictions being placed on lending without analyzing a borrower's solvency based on the PTI and LTV coefficients. The representatives of the banking sector do not expect a significant change of non-interest conditions for individual lending.

In March, compared to December, interest rates on loans issued to small and medium enterprises increased by 0.5 pp and equaled 10.3%. Interest rates for corporate loans did not change significantly and stood at 8.8%, while interest rates on retail loans rose by 1.2 pp and equaled 16% (see Figure 5.6). Over the same period the average interest rates on the stock of legal entities declined slightly in foreign currency loans, while these did not change significantly for loans in the domestic currency (see Figure 5.7). Representatives of the banking sector expect a slight decrease of interest rates on fixed interest rate loans in foreign currency and a reduction of the margin on variable interest rate loans in the domestic currency.

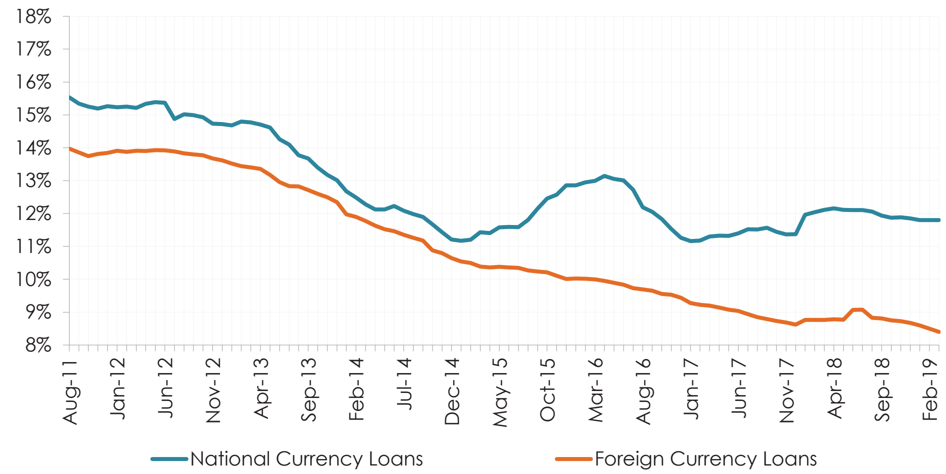
« Representatives of the banking sector do not expect a significant change of non-interest conditions for individual lending.

Figure 5.6 Interest rate on loan flow



Source: National Bank of Georgia

Figure 5.7 Average interest rates on business loans



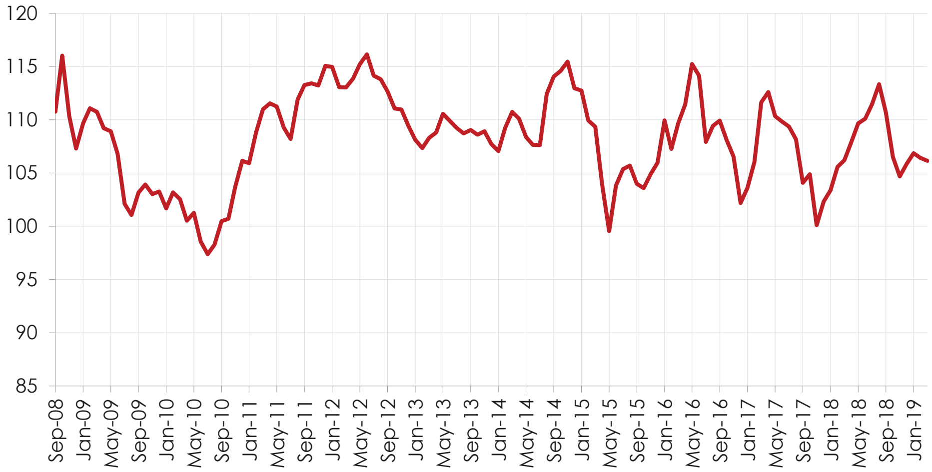
Source: National Bank of Georgia

5.3. EXCHANGE RATE

In the first quarter of 2019, the GEL nominal effective exchange rate appreciated against the US dollar by 0.3% and against the euro by 0.7% compared to the previous quarter. Meanwhile, the GEL depreciated slightly against the Russian ruble and Turkish lira by 0.4% and 2.2% respectively. As a result, the nominal effective exchange rate depreciated by 0.6% on a quarterly basis and appreciated by 4.6% on an annual basis. As for the price-adjusted exchange rate, the real effective exchange rate appreciated by 0.8% on a quarterly basis and by 1.4% on a year-on-year basis. Despite this appreciation, the real exchange rate is still within a competitive range as a result of the depreciation in previous periods.

When adjusted for commodity groups and services, the nominal effective exchange rate reveals a slightly different picture. In the first quarter of 2019, the adjusted nominal effective exchange rate appreciated by 1.4% on a year-on-year basis and depreciated by 0.5% compared to the previous quarter.

Figure 5.8 Real effective exchange rate (Jan 2008=100)



Source: National Bank of Georgia

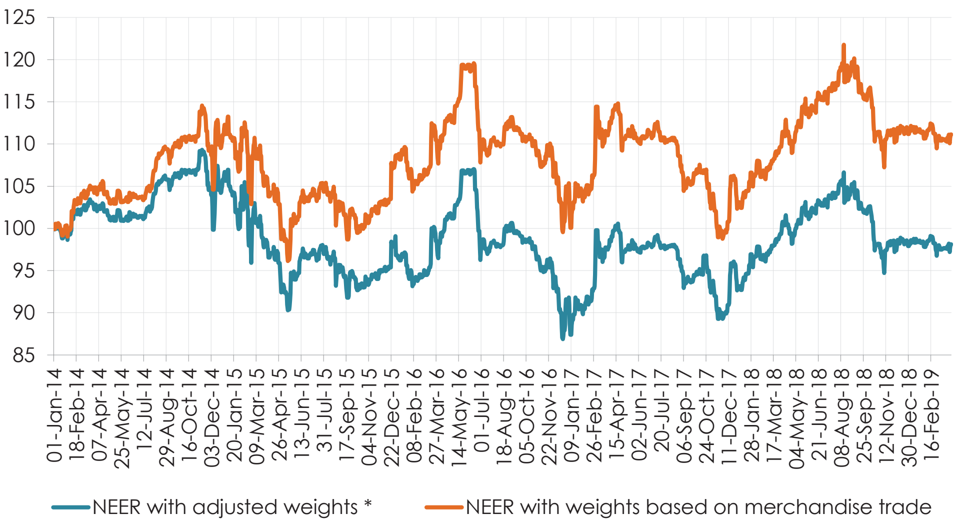
Table 5.1 Effective exchange rates annual growth (1st quarter 2019)

	Change of Nominal Exchange Rate, %	Change of Real Exchange Rate, %	Share in Real Effective Exchange Rate, pp
Effective exchange rate*	4.6	1.4	1.4
Eurozone	0.7	2.1	0.5
Turkey	31.1	12.3	2.1
Ukraine	-6.8	-12.1	-0.9
Armenia	-5.9	-4.7	-0.3
The United States	-6.9	-5.9	-0.3
Russia	8.1	5.6	0.8
Azerbaijan	-6.9	-6.4	-0.7
Other	-0.2	0.4	0.1

* The growth implies appreciation of lari

Source: National Bank of Georgia

Figure 5.9 Corrected nominal effective exchange rate



* Calculation of the index for the adjusted nominal effective exchange rate includes weights based on trading with only those goods and services (tourism) that are sold in the currency of a partner country. Increase = appreciation. 31 Dec. 2013 = 100.

Source: National Bank of Georgia

Box 2 Alternative sources of finance

Commercial banks play a significant role in the modern economic and financial system. In particular, commercial banks, as financial intermediaries, are efficiently distributing resources between savers and borrowers reducing risks and lowering the asymmetry of information on the market. However, despite their role, commercial banks rarely fund startups, either in Georgia or the rest of the world. Yet access to capital is essential for startups – it enables them to cover initial costs and invest in product development. As a result, entrepreneurs have to seek alternative sources of financing and often rely on their own savings. Number of studies reveal, they are often forced to rely of their own and family savings to cover initial costs. According to the Annual Survey of Entrepreneurs, around 63.9% of startups are financed through personal and family savings.[15] Other than personal savings, venture capital firms represent an important source of funding for startups. Such firms provide financial and strategic support; they help startups develop strategies and introduce them to potential customers and partners. However, it can be relatively difficult to obtain finance from venture capital firms as they tend to be focused on certain industries (high-tech, biotechnological, etc.).

In addition to venture capital firms, there are so-called "angel investors" who act like venture investors. Such individuals primarily fund startups and SME's, assisting them in developing their products and strategies. It is important to note that such investors finance the initial stages of a company's establishment, and in return they typically require the right to supervise the company's activities. In different countries, investors' unions exist where information is available about investors' interests and specific needs. It should be noted that "informal" individual investors funded companies such as Google and Costco[16]. However, it is also important to note that, in return for the high risk of the investments, both individual investors and venture capital firms tend to expect high profits in a relatively short period.

State programs and grants are other sources of funding for startups. In a number of countries, state-owned funds define priority directions and can be used to finance companies that satisfy those criteria. It should be noted that such state funds are present in Georgia. The Partnership Fund, Techpark and others finance high-tech firms and other startups that satisfy the set criteria. Unlike with private and venture investors, the funding provided by state grants and funds tend to be longer-term and the state's financial interests in the company's profit is relatively small.

In addition to these sources of finance, the market allows startups to raise capital from a number of investors simultaneously through crowdfunding. There are different platforms present in developed countries through which startups are able to present projects and raise necessary funds. The likes of Kickstarter, Indiegogo and other internet platforms enable anyone to present their projects to the public to secure funding.

Compared to other countries, Georgia offers relatively limited sources of alternative funding for startups; however, various state projects and banking programs exist to support entrepreneurs.

15 *The US Census Bureau. 2016. Annual Survey of Entrepreneurs ASE. Available online at: https://www.census.gov/programs-surveys/ase.html .*

16 *An American multinational corporation, one of the largest retail trade companies in the world.*

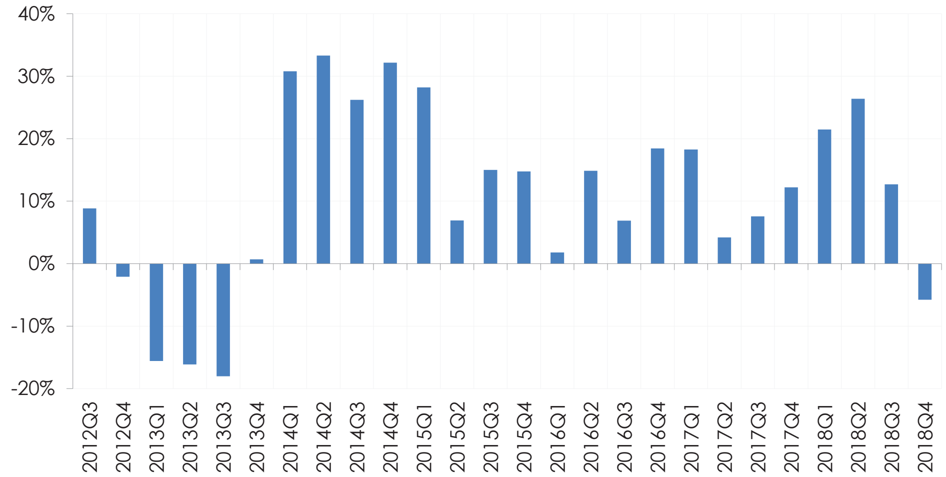
6. Aggregate Demand

In the fourth quarter of 2018, GDP grew by 4.5% in real terms. This growth was mainly driven by consumption. The contribution of net exports was comparatively less, while the contribution of capital formation was negative.

In the fourth quarter, final consumption expenditures rose by 10.7%. An important part of this growth came from household consumption, which grew by 12.5% in the same period. As a result, the real growth of household consumption was 10.4%.[17] This number substantially exceeds the GDP real growth rate and indicates a revival of domestic demand. At the same time, government expenditures grew by 4.6% in nominal terms.

‹‹ In the fourth quarter, GDP growth was mainly driven by consumption.

Figure 6.1 Annual growth rate of capital formation

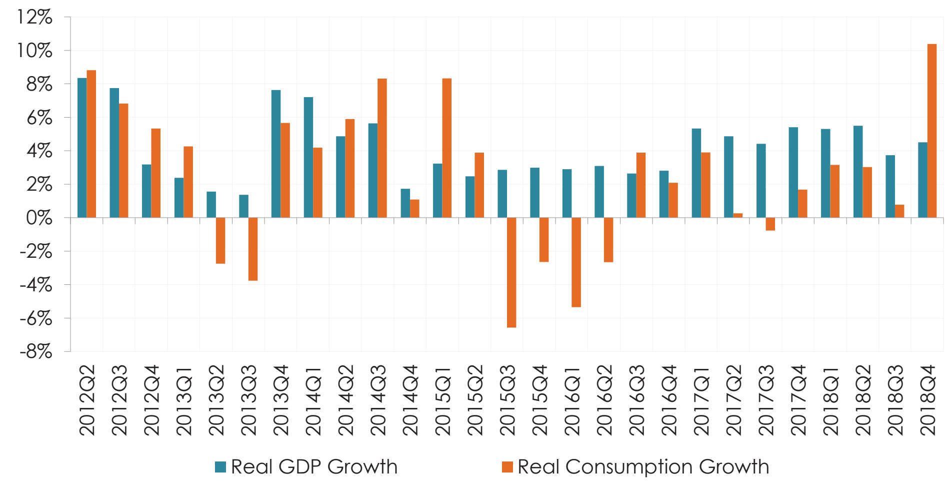


Source: GeoStat

After strong growth in first three quarters of 2018, the volume of investments fell by 5.7% in the fourth quarter. Both capital formation and inventories shrank. As a result, investments negatively contributed to economic growth. This reduction of investments can, to some extent, be linked to a decrease in the output of construction.

‹‹ Weakened growth of final consumption is a sign of weak domestic demand.

Figure 6.2 Real GDP and real consumption growth



Source: GeoStat and National Bank of Georgia

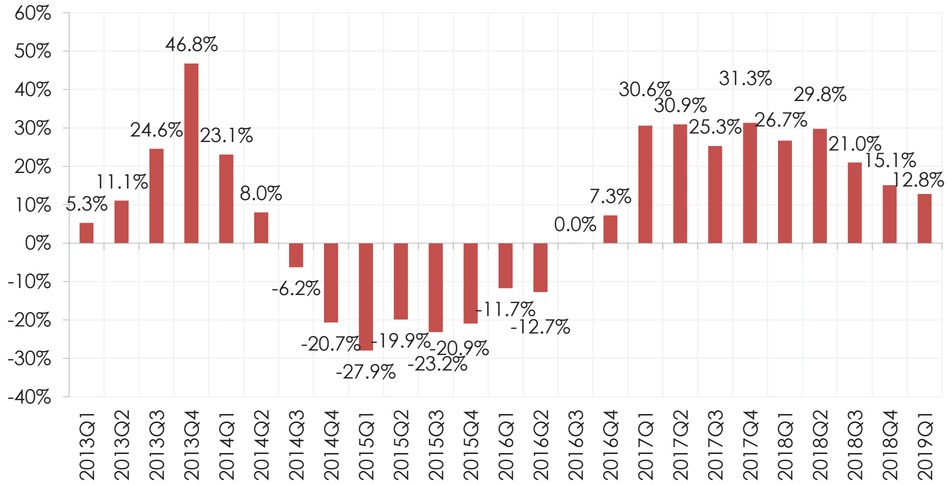
17 *The real growth of consumption is calculated using average annual inflation.*

7. External Demand and Balance of Payments

The external sector was active from the very beginning of 2019 and this was reflected in higher revenues from exports, increased money transfers and higher revenues from tourism. In the first quarter of the year, registered exports of goods grew by 13% annually (see Figure 7.1), which mostly stemmed from increased exports of consumption and intermediate goods. Higher growth rates were also evident for exports of ferroalloys, natural wines and bottled waters. Compared to the same period of the previous year, re-exports of motor cars, medicaments, copper ores and concentrates also became much more active. In contrast, exports of alcoholic beverages, cigarettes and hazelnuts/nuts were considerably lower.

‹‹ In the first quarter of 2019, registered exports of goods increased by 13% annually.

Figure 7.1 Annual change in registered exports of goods



Source: GeoStat

The volume of exports to Georgia's main trading partners, with exception of Turkey, significantly increased because of increased external demand stemming from the improved economic situations in those countries. Compared to the same period of the previous year, exports were significantly higher to Russia (ferroalloys, natural wines and alcoholic beverages), China (copper ores and concentrates) and EU countries, especially to Romania and Bulgaria. Trade was also higher to other CIS countries, particularly to Kyrgyzstan and Uzbekistan.

Export of goods increased mainly due to the increase in demand of consumer and intermediate goods. In the first quarter of 2019, the exports of consumer goods grew by 14%, mainly because of higher exports of motor cars, natural wines, bottled waters and cigarettes. Exports of ferroalloys and copper ores and concentrates also considerably increased. It is worth noting that exports of goods in terms of commodity groups became less diverse during the last quarters. The overall increase in exports was mainly due to higher levels of re-exports.

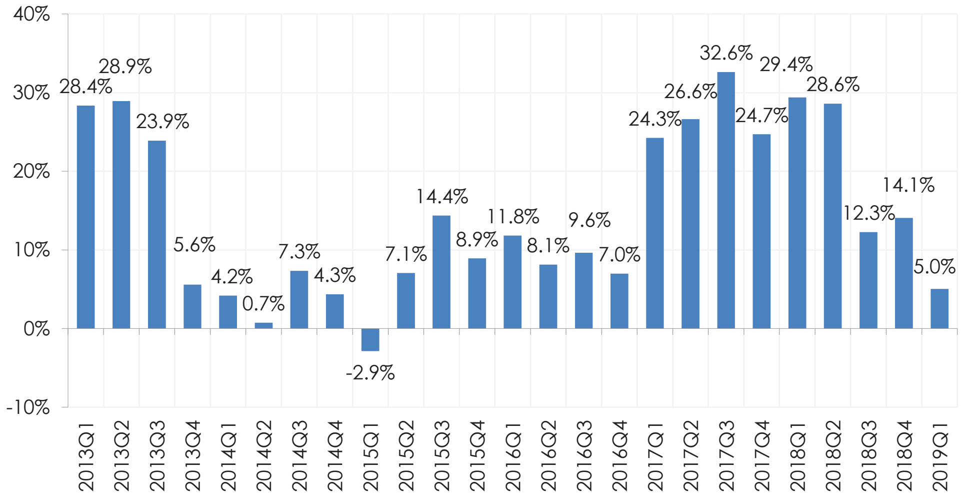
Figure 7.2 Annual change in registered exports of goods by category

Source: National Bank of Georgia

The increase of external demand also affected exports of services, especially tourism. In the first quarter of 2019, revenues from tourism reached 578 million USD, which is 5% more than the same period of last year (see Figure 7.3). Because there was a lower growth in revenues from tourism from the second half 2018, mainly due to reduced numbers of visitors (mostly from Turkey and Iran), it is likely that revenues from tourism will accelerate in the second half of 2019.

‹‹ In the first quarter of 2019, revenues from tourism increased moderately, by 5% annually.

Figure 7.3 Annual change in revenues from tourism

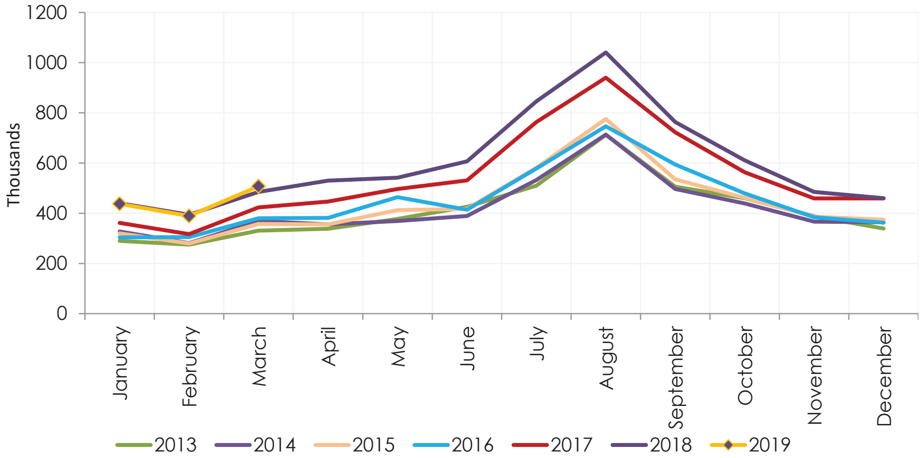


Source: National Bank of Georgia

The rise in revenues from tourism was a result of an increasing number of international visitors, especially tourists.[18] In 2018, the number of visitors grew not only for leisure and recreational reasons, but also for business and professional purposes. Moreover, the number of repeat visitors accompanying family members or relatives substantially increased. In the first quarter of 2019, the number of foreign visitors entering Georgia grew by 1.1% (see Figure 7.4), the majority of whom (64%) were tourists. Travelers from Azerbaijan and Russia made the most significant contribution to this growth, in terms of both the number of arrivals and the revenues from tourism. On the other hand, tourist inflows from Turkey and Armenia contributed negatively to the overall growth of visitors and revenues from tourists from those countries also declined. At the same time, there was a substantial increase in the number of visitors from Israel and EU countries, especially from Poland.

18 *A tourist is defined as a visitor who remained in the country for more than 24 hours.*

Figure 7.4 Number of international visitors to Georgia

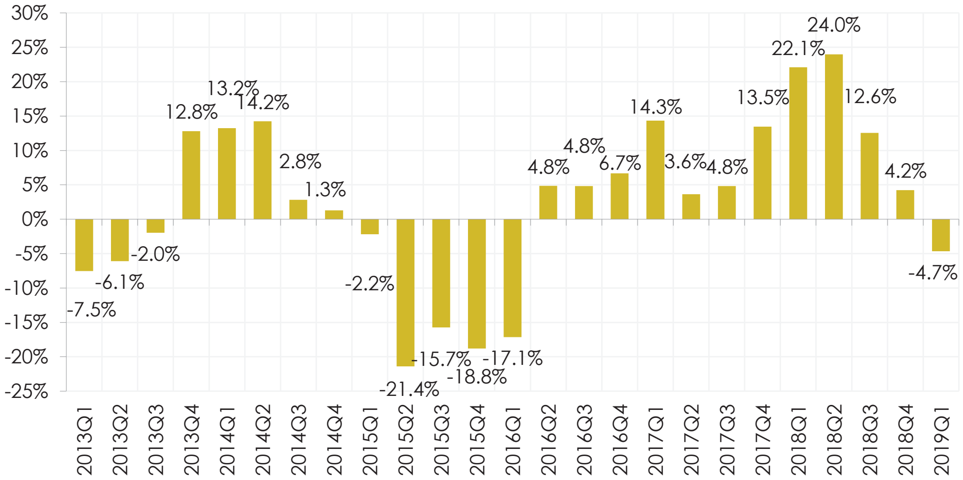


Source: GNTA

The growth of imports decelerated from the second half of 2018, and actually began to decrease from the beginning of 2019. The latter dynamic was due to the base effect (in March 2018, there was a one-off increase in import items) as well as the reduction of FDI. In the first quarter of 2019, the growth rate of imports of goods fell by 4.7% (see Figure 7.5). As had been the case previously, imports decreased from CIS countries as well as from the EU. The decline in imports from CIS countries was mainly due to lower imports from Russia (particularly petroleum products) and Ukraine (cigarettes). From EU countries, imports declined substantially from France (due to one-off import items) and from the Netherlands (due to gas turbines).

« In the first quarter, the growth rate of imports was lower by 4.7%.

Figure 7.5 Annual change in registered imports of goods

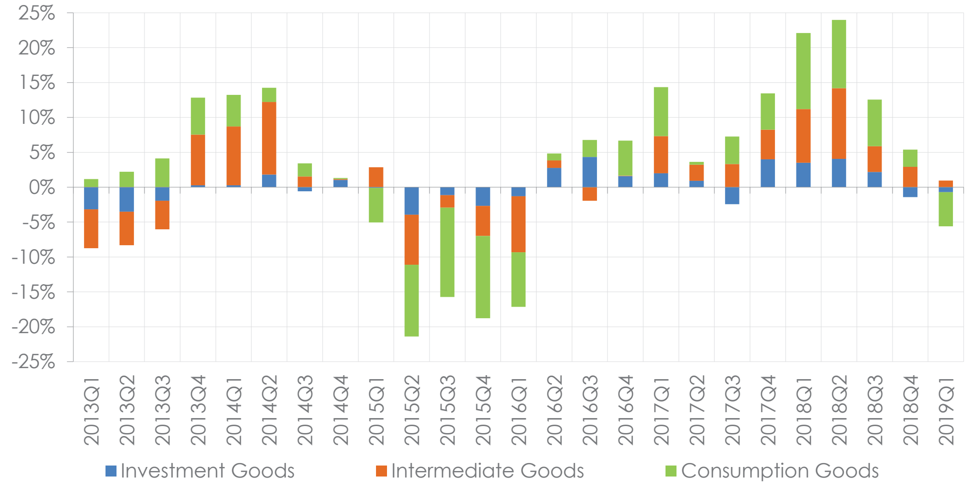


Source: GeoStat

In the first quarter of 2019, imports of intermediate and consumer goods accounted for 40% and 46% of total imports respectively. It is worth noting that the decline in imports of goods stemmed from the decrease in consumer goods (making a -4.9 percentage point contribution to the overall import change). During this period, imports of intermediate goods decreased by 11.4% (see Figure 7.6). This reduction was due to the decline in one-off import items and petroleum products (the latter being a result of lower petroleum prices on global markets). Imports of intermediate goods increased by 2.2% (making a 0.9 percentage points contribution), while imports of investment goods declined by 5% (-0.7 percentage points in the overall import change). In sum, the decline in imports was due to one-off items. Without considering those, there would have been an increase in investment goods imports. It is worth noting that, in terms of commodity groups, imports of goods have become less diverse compared to the same period of last year.

« The decline in consumption goods imports is due to the lower import of petroleum and one-off imports.

Figure 7.6 Annual change in registered imports by category of goods

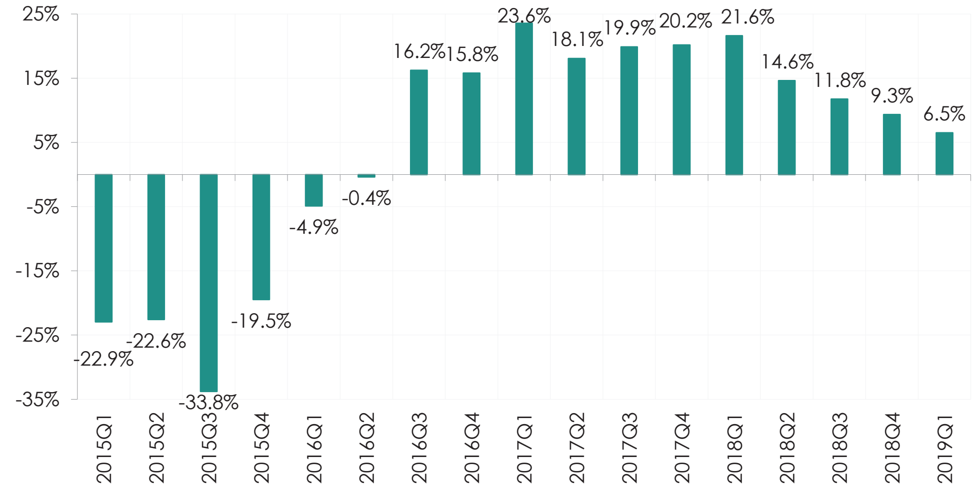


Source: GeoStat

Money transfers to Georgia once more showed an increasing trend, although the growth rate has slowed. In the first quarter of 2019, money transfers to Georgia increased by 6.5% annually (see Figure 7.7). This was mainly driven by increased transfers from the European Union (notably from Italy, Greece and Poland) and the USA. In contrast, money transfers from Russia and Turkey showed a decreasing trend from the second half of the year, which continued into the first quarter of 2019. Transfers from Russia and Turkey thus negatively contributed to the overall change in money transfers compared to the same period last year.

« In the first quarter of 2019, the volume of money transfers to Georgia increased by 6.5% annually.

Figure 7.7 Annual change in remittances

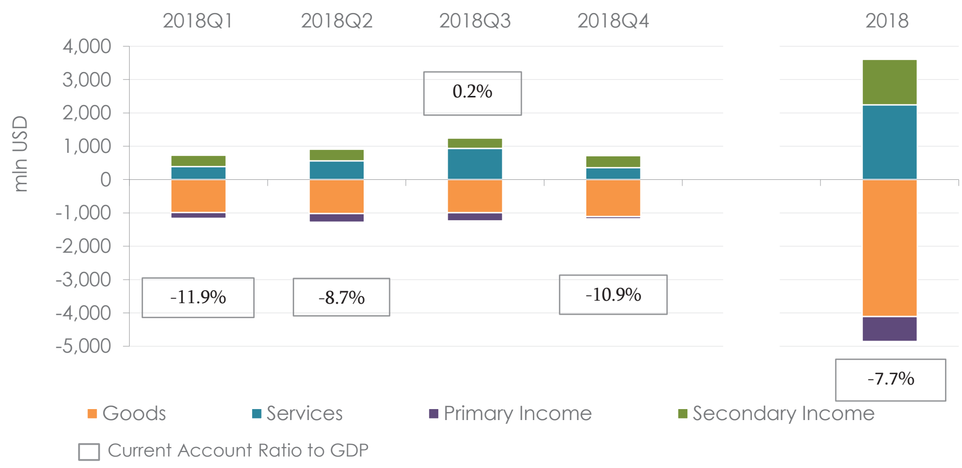


Source: National Bank of Georgia

Thanks to the high growth of exports of goods and services, rising money transfers to Georgia and a reduction in imports, the current account deficit amounted to 458 million USD in the fourth quarter of 2018, which is 10.9% of GDP. This deficit was 2.4 percentage points lower (by 80 million USD) than the same period of last year.

It is worth noting that compared to 2017, the current account balance improved significantly, amounting to 7.7% of GDP in 2018. This current account balance improvement was due to trade in services, especially revenues from tourism and secondary income such as the increase of personal transfers from abroad.

Figure 7.8 The current account balance by components



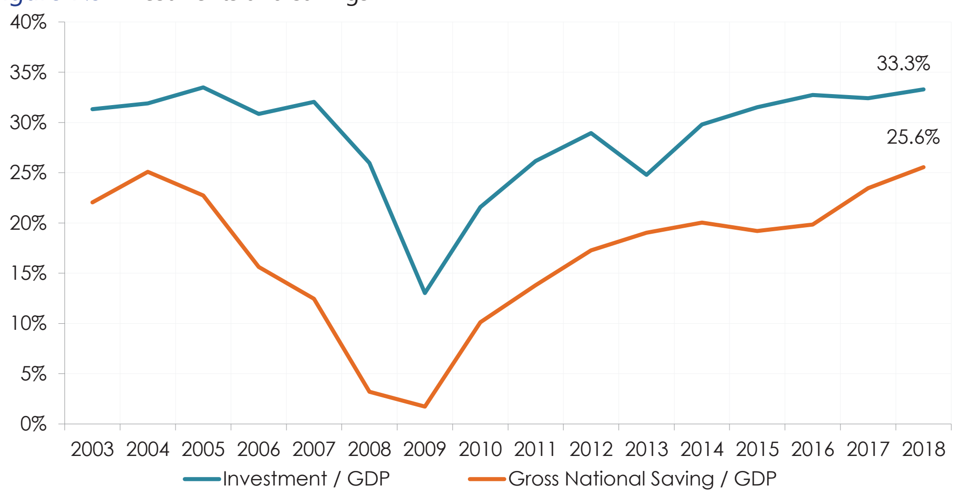
Source: National Bank of Georgia

Foreign direct investments (FDI) remain the primary source of financing the current account. In the fourth quarter of 2018, the volume of foreign direct investments declined by 62% annually and equaled 197 million USD. It is worth noting that the completion of the final phase of the BP pipeline project and the movement of several enterprises into the possession of Georgian residents both affected the level of FDI. In 2018, the largest part of FDI went to the finance, transport and energy sectors, each receiving 23% (278 million USD), 17% (210 million USD) and 13% (157 million USD) of total FDI respectively.

« In 2018, the decrease in FDI was mainly due to the completion of the final phase of the BP pipeline and transmission of ownerships of several companies to Georgian resident units.

An analysis of investments and savings reveals that the improvement of the current account in 2018 stemmed from a higher increase in savings rather than in investments. In 2018, compared to 2017, the ratio of investments to GDP increased by 0.9 pp to reach 33.3%, while the ratio of savings to GDP grew by 2.1 pp to 25.6% (see Figure 7.9).

Figure 7.9 Investments and savings



Source: GeoStat and calculations of the National Bank of Georgia

8. Output and labor market

8.1 OUTPUT

In the fourth quarter of 2018, GDP grew by 4.5% compared to the same period of last year. That growth was primarily driven by services, which contributed 4.6 percentage points (pp) to the total. The contribution of agriculture to growth was 0.3 pp, while industry made a negative contribution of -0.3 pp.

As was the case in previous periods, the increased number of foreign visitors was the main source of economic growth. Participation of foreigners is important for real estate operations, where growth in the fourth quarter surged to 10.7%, contributing 0.7 pp to overall GDP growth. A large contribution to the fourth quarter's growth came from transport, which leaped by 12.6% to make a contribution of 0.7 pp. A substantial share of that growth came from travel agencies, tour operators and air transport – all of which further underlines the significance of the enlargement of the tourism industry. Foreigners' participation is also important for the output of hotels and restaurants, which grew by 16.1%, contributing 0.4 pp to total growth.

‹‹ The increased number of foreign visitors is still the main source of economic growth.

Trade, which is the largest branch of the economy, grew by 6.1% in the fourth quarter, contributing 0.9 pp to GDP growth. Like in the third quarter, in the fourth quarter, this growth came from wholesale trade, which rose by 12.4% in nominal terms. On the contrary, retail trade decreased by 1%. In terms of other services, growth was high in the financial sector (8.9%, making a 0.3 pp contribution to total growth) while communication grew by 10%, contributing 0.2 pp to overall growth.

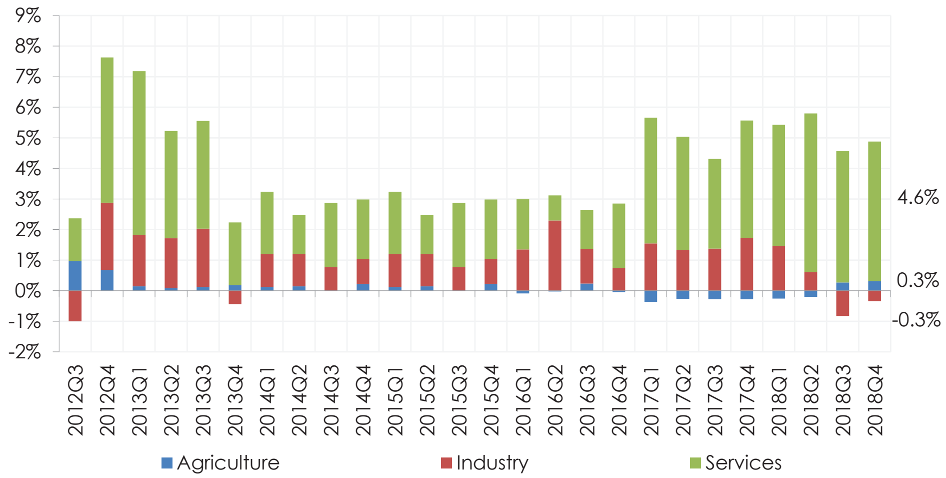
Agriculture grew by 5.4% and contributed 0.3 pp to overall GDP growth. It is noteworthy that the declining trend of agricultural output, which started in the fourth quarter of 2016, finally turned into growth during last two quarters.

‹‹ Contributions of trade and agriculture to GDP growth are still positive.

A number of infrastructural projects financed by the government were activated in the fourth quarter, where the nominal growth equaled 30% over the corresponding period of last year. However, presumably due to a real decline in private construction, where the nominal growth was slight, total construction declined by 2.4% and the contribution of this sector to overall growth was negative at -0.2 pp.

‹‹ The contribution of construction to GDP growth remains negative.

Figure 8.1 Contribution of sectors of economy to real GDP growth



Source: GeoStat.

8.2 LABOR MARKET

In the third quarter of 2018, labor productivity per worker increased by 5.2% compared to the same period of the previous year. In the same period, labor productivity in the agriculture and services sectors increased by 19.1% and 4% respectively, while productivity decreased by 12.2% in the industrial sector (see Table 8.1). In the third quarter, the growth of GDP and productivity was mainly driven by the services and agriculture sectors. The increase of international visitors supported the growth of

‹‹ Labor productivity increased by 3.8% due to agriculture.

the restaurants and hotels, real estate operations and transport sectors. The overall increase in labor productivity in services was 4%.

The output of the agriculture sector increased by 3.8%, while the amount of labor employed in the sector declined by nearly 13%. Labor productivity per worker thus increased by 19.1%.

Labor productivity in the industrial sector declined by 12.2%, which follows the 22% increase in employment in the construction sector compared to the previous year, while the output declined by 9.2%. Consequently, the labor productivity per worker in construction decreased by 25%. This decline can be linked to the slowdown of both certain publicly funded infrastructural projects and private constructions. However, it is important to note that the reporting period between the growth of the number of workers employed in construction and the value added per labor is longer than for other sectors of the economy. We can thus assume that the productivity of labor in the construction sector will increase in the next reporting period. Meanwhile, productivity slightly decreased in the manufacturing sector by 0.6%, where output increased by 0.1%, while the labor employed grew by 0.8%.

‹‹ Productivity has declined in industry and services.

Table 8.1 Annual growth of value added per employee in the fourth quarter of 2018

	Increase in labor productivity
Agriculture and agriculture output by households	18.6%
Industrial sector	-9.6%
Services sector	-5.4%
Overall in the economy	**3.8%**

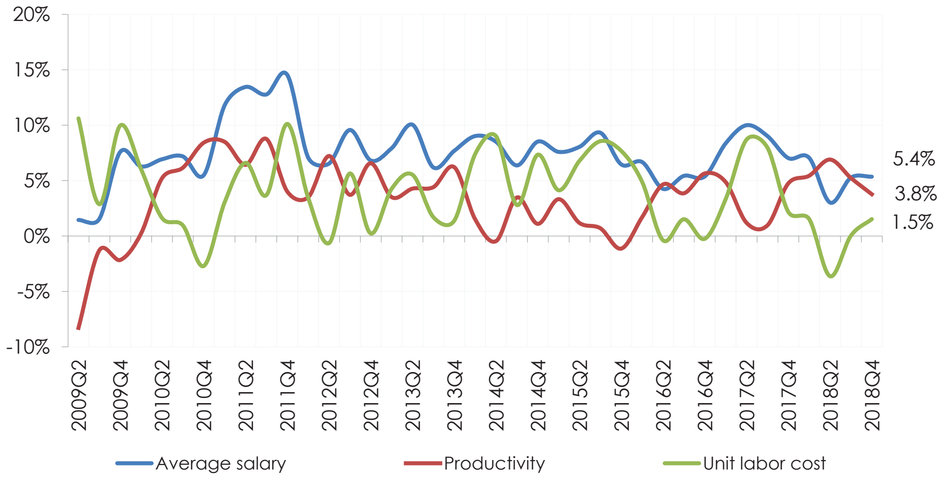
Source: GeoStat

In the fourth quarter of 2018, the average annual nominal growth of wages was 5.4%. According to GeoStat estimates, the average monthly salary in the economy was 1,202 GEL. In the fourth quarter of 2018, the unit labor cost grew by 1.5% (see Figure 8.2). Thus, the labor market has not created inflationary pressure in the economy.

‹‹ Average salaries grew by 5.4% annually.

‹‹ Unit labor cost rose by 1.5%.

Figure 8.2 Labor productivity, average monthly salary, unit labor cost (annual percentage change)



Source: GeoStat and National Bank of Georgia

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